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RECENT DEVELOPMENTS IN TEXAS CORPORATION LAW—PART II*

by

J. Leon Lebowitz**

VI. CORPORATE FINANCE

A. Corporate Securities

Several of the 1973 legislative changes had an impact on the TBCA provisions relating to corporate securities. Some of these have already been discussed, such as the amendments concerning the incorporation by reference procedure⁹⁰² and notation of restrictions on transfer as they affect share certificates,⁹⁰³ permitting variations of voting rights if preferred or special classes may be issued in series⁹⁰⁴ and affecting the class voting rights of holders of such shares,⁹⁰⁵ and recodifying the law relating to preemptive rights.⁹⁰⁶ Others are briefly noted here along with several pertinent decisions.

Share Certificates. An amendment to section B of article 2.19⁹⁰⁷ allows a corporation which is authorized to issue more than one class of shares or which has chosen to limit or deny preemptive rights, in lieu of setting forth such matters in full on the face or back of its certificates, the option of stating instead that the corporation will furnish without charge a full statement of the relative rights, etc. of such classes or limitation or denial of preemptive rights to any shareholder upon written request at the corporation's principal place of business or registered office and that such information is also on file in the office of the secretary of state.⁹⁰⁸ The change was suggested by a comparable Model Act provision,⁹⁰⁹ and follows the contemporary practice that the interests of economy and convenience reduce the need for the often

* Editor's Note: This is the second of a two-part Article, Part I of which appears in the Fall issue, 28 *Southwestern Law Journal* No. 4, pp. 641-764. Footnote numbering is continuous throughout the two parts. Material cross-referenced to footnotes 1-901 will be found in Part I.

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902. See discussion in text accompanying notes 41-60 *supra*.

903. See discussion in text accompanying notes 557-70 *supra*.

904. See discussion in text accompanying notes 261-72 *supra*.

905. See discussion in text accompanying notes 273-96 *supra*.

906. See discussion in text accompanying notes 713-74 *supra*.

907. Ch. 545, § 10, [1973] Tex. Laws 1490, amending TEX. BUS. CORP. ACT ANN. art. 2.19(B) (1956).

908. The new close corporation statutes have comparable provisions as to the legend that must be placed on share certificates to note the existence of an agreement among all the shareholders permitted by article 2.30-2 or a provision of the articles of incorporation giving a shareholder the option to dissolve the corporation. See TEX. BUS. CORP. ACT ANN. arts. 2.30-2(C), 2.30-5(B) (Supp. 1974). Any change in language on share certificates made to take advantage of the amendment does not apply to or affect outstanding certificates, but must be stated on any certificates thereafter issued in connection with an initial issuance or subsequent transfer of shares. *Id.* art. 2.19(E) (Supp. 1974).

909. ABA MODEL BUS. CORP. ACT ANN. § 23 (2d ed. 1971) [hereinafter cited as ABA MODEL BUS. CORP. ACT ANN. 2d].

microscopic reproduction of the preferred share contract and other required legends on share certificates, and substitutes a statement that the desired information will be furnished on request or is available as a matter of public record.⁹¹⁰

Stock Rights, Options, and Convertible Indebtedness. A new provision has been added to the TBCA expressly authorizing the corporation to create or issue rights or options entitling their holders to purchase any of its classes of shares or other securities or to create and issue convertible debt securities, subject of course to any limitations expressed in the articles of incorporation.⁹¹¹ The board of directors must approve the manner in which such rights, options, or indebtedness is to be evidenced and their terms and conditions, including the fixing of purchase prices or conversion ratios and times for exercising the underlying privileges.⁹¹² While the issuance of such rights and convertible indebtedness was probably sustainable under the more general powers conferred on corporations by the TBCA,⁹¹³ the Bar Committee, influenced no doubt by a comparable Model Act section,⁹¹⁴ felt that in view of the increasing importance and usage of such securities it was desirable that express statutory authorization for their issuance be enacted.⁹¹⁵

Fractional Shares. Article 2.20 dealing with fractional shares or scrip has been amended to sanction additional arrangements for the handling of fractional shares.⁹¹⁶ As amended, the corporation is authorized to (1) issue fractional shares, (2) arrange for their disposition, (3) pay in cash their fair value as of the time when those entitled to receive them are determined, or (4) issue scrip to be used to acquire a full share. The change is designed to accommodate the fairly common practice of designating an agent to buy or sell fractional shares in behalf of shareholders receiving them, usually as the consequence of exchanges of securities in acquisition situations, so that the fractions can be combined into whole shares.⁹¹⁷

Consideration for the Issuance of Shares. In its desire to provide creditors or sometimes all the shareholders of corporations with an economic cushion

910. *Id.* ¶ 2.

911. Ch. 545, § 8, [1973] Tex. Laws 1489, adding TEX. BUS. CORP. ACT ANN. art. 2.14-1 (Supp. 1974).

912. *Id.*

913. The power to issue convertible debt was seemingly authorized by TBCA art. 2.02(A)(9), the general contract and borrowing power that includes the issuance of "notes, bonds, and other obligations," as well as article 2.15 dealing with the consideration for the issuance of shares. The same articles also apparently authorized the issuance of stock options and rights. See TEX. BUS. CORP. ACT ANN. arts. 2.02(A)(9), 2.12, 2.15 (Supp. 1974); 19 R. HAMILTON, TEXAS PRACTICE: BUSINESS ORGANIZATIONS § 404 (Supp. 1974) [hereinafter cited as R. HAMILTON, TEXAS BUSINESS ORGANIZATIONS].

914. ABA MODEL BUS. CORP. ACT ANN. 2d, § 20.

915. Comment of Bar Committee to Art. 2.14-1, 3A TEX. REV. CIV. STAT. ANN. 44 (Supp. 1974).

916. TEX. BUS. CORP. ACT ANN. art. 2.20 (Supp. 1974), as amended by ch. 545, § 11, [1973] Tex. Laws 1492.

917. Doty & Parker, *Changes in the Texas Business Corporation Act and Related Statutory Provisions*, 10 HOUSTON L. REV. 1009, 1015 (1973) [hereinafter cited as Doty & Parker].

of sorts, as manifested by the "trust fund" doctrine,⁹¹⁸ Texas law by both constitution⁹¹⁹ and statute⁹²⁰ has prescribed the quantity and quality of consideration for which shares are to be issued.⁹²¹ Given the variety of circumstances under which stockholders acquire shares, it is not surprising that litigation occasionally arises concerning their issuance, or even that a statute as explicit as the TBCA on the subject must be amended now and then to provide further clarification.

The TBCA amendments on the subject are found in part in the new legislation on stock rights, options and convertible indebtedness, just described.⁹²² Thus, in authorizing such securities, new article 2.14-1 provides that in the absence of fraud the judgment of the directors as to adequacy of the consideration received for their issuance shall be conclusive. If shares, other than treasury shares, that have a par value are to be issued on the exercise of a right or option, the price received cannot be less than par value. Similarly, conversion of indebtedness is not permitted if the corporation would receive less than the minimum consideration required to be received for the issuance of shares upon such conversion. The latter requirement is spelled out in a new section E, taken directly from the Model Act,⁹²³ that has been added to article 2.15.⁹²⁴ When shares are issued upon conversion of indebtedness or other shares, the consideration for their issuance is to be (1) the principal sum of, and accrued interest, on the debt security being converted or the stated capital represented by the equity security, (2) that part of surplus, if any, transferred to stated capital upon such issuance, and (3) any additional consideration paid to the corporation at the time.

The courts, too, were asked to rule on the validity of the issuance of shares in three recent cases, but in only one were sufficient facts stated to make the court's holdings on the matter helpful as authority. In *Austin Lake Estates Recreation Club, Inc. v. Gilliam*,⁹²⁵ for example, the trial court's judgment included an order cancelling shares held by three members of the majority faction, based on jury findings they had been issued without full consideration being paid to the corporation. One of the three contended his shares had been acquired in exchange for the cancellation of two notes of the club and to repay petty cash advances. The appellate court assumed without deciding that the exchange of stock for the cancellation of the debt would constitute valid payment for the shares⁹²⁶ but held nevertheless that

918. See discussion in text accompanying, and authorities cited in, notes 868-69 *supra*.

919. TEX. CONST. art. XII, § 6.

920. TEX. BUS. CORP. ACT ANN. art. 2.16 (Supp. 1974).

921. See generally 19 R. HAMILTON, TEXAS BUSINESS ORGANIZATIONS § 391; Comment, *Some Problems Raised by Issuing Stock for Overvalued Property and Services in Texas*, 40 TEXAS L. REV. 376 (1962).

922. See TEX. BUS. CORP. ACT ANN. art. 2.14-1 (Supp. 1974) and discussion in text accompanying notes 911-15 *supra*.

923. ABA MODEL BUS. CORP. ACT ANN. 2d, § 18, third paragraph.

924. TEX. BUS. CORP. ACT ANN. art. 2.15(E) (Supp. 1974), as amended by ch. 545, § 9, [1973] Tex. Laws 1490.

925. 493 S.W.2d 343 (Tex. Civ. App.—Austin 1973), error ref. n.r.e., discussed in text accompanying notes 474-85 *supra*.

926. See, e.g., *Robinson v. Malheur Pub. Co.*, 272 F. Supp. 57, 60 (D. Ore. 1967) (Oregon law); *United States v. Cole*, 90 F. Supp. 147, 150 (S.D. Cal. 1950) (dictum; applying CAL. CORP. CODE § 1109(d) (West 1955) allowing shares to be issued for

there was other evidence (without stating it) that supported the jury's findings.

A similar result occurred in *Gulf States Abrasive Manufacturing, Inc. v. Oertel*,⁹²⁷ an action by a former employee against his corporate employer for the conversion of 25,000 shares of its stock he claimed it had wrongfully cancelled. The corporation asserted that the shares had been improperly issued to him because the consideration given had been a promissory note, prohibited as consideration by the TBCA,⁹²⁸ or else was to be paid for out of future bonuses; the jury, however, found that the shares had been issued for the plaintiff's prior work in organizing the corporation and getting its product on the market and he was awarded a judgment on that basis. Again no evidence was stated to show the basis for the findings. The corporation tried to invoke judicial estoppel to overturn the judgment because the plaintiff had alleged under oath in a federal tax proceeding that he had not received the shares in the taxable year in question or that if he had, they were not compensation or income to him. But because the corporation had failed to plead estoppel, it was held to have waived the affirmative defense. Nor was the plaintiff found to have consented to the issue being tried, even if he had not objected to the admission of a certified copy of his sworn petition in the tax case.

The one useful decision is *Hatcher v. Jack Miller Milling Corp.*⁹²⁹ The suit was brought to enforce three promissory notes given by the defendant to three separate corporations to purchase stock in each. He defended on the basis that the notes were void because given for the unpaid balance of the purchase price of shares and therefore prohibited by the Texas Constitution and the TBCA.⁹³⁰ In affirming the judgment against him, the court held that while under both the constitution and statute a promissory note cannot constitute payment for the shares, the facts showed no shares were issued to the defendant until he had made payment on the note in cash. Had he tendered the balance that he owed on the notes he would have received the shares he was entitled to; the corporations therefore were likewise entitled to have the notes paid at which time they would issue the shares. In short, the notes were valid and enforceable.

Under the facts stated, there can be no quarrel with the court's holding which is in accord with the general rule.⁹³¹ So long as the shares are not

"debts or securities canceled"); *Richardson v. Graham*, 45 W. Va. 134, 30 S.E. 92 (1898); 11 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5197 (perm. ed. 1971) [hereinafter cited as W. FLETCHER, CYCLOPEDIA CORPORATIONS]. There appears to be no Texas authority in point, *but cf.* *Jackson v. Gish*, 440 S.W.2d 121 (Tex. Civ. App.—Waco 1969), *error ref. n.r.e.*, discussed in Hamilton, *Corporations and Partnerships, Annual Survey of Texas Law*, 24 Sw. L.J. 91, 106 (1970) (shareholders ratified issuance of shares to directors because they had worked without adequate compensation for four years and corporation did not have sufficient cash to pay reasonable salary).

927. 489 S.W.2d 184 (Tex. Civ. App.—Houston [1st Dist.] 1972), *error ref. n.r.e.*, discussed in text accompanying notes 576-79 *supra*.

928. TEX. BUS. CORP. ACT ANN. art. 2.16(B) (1956).

929. 501 S.W.2d 439 (Tex. Civ. App.—Texarkana 1973), *error ref. n.r.e.*

930. TEX. CONST. art. XII, § 6; TEX. BUS. CORP. ACT ANN. art. 2.16(B) (1956).

931. See, e.g., *McCarty v. Langdeau*, 337 S.W.2d 407, 412 (Tex. Civ. App.—Austin 1960), *error ref. n.r.e.*; *Zapp v. Spreckels*, 204 S.W. 786, 788 (Tex. Civ. App.—Galve-

issued until paid for, the giving of a promissory note is analogous to a subscription for shares, which, depending upon its terms, is callable in installments or in full at the discretion of the board of directors.⁹³²

Redemption. The TBCA provides in some detail the procedure to be followed in redeeming shares, including the notice to be given holders of such shares,⁹³³ but typically has no comparable provision for redemption of debt securities. The redemptive process and the notices to be given are regarded as a matter of contract between the issuer, the debt security holder, and probably the indenture trustee, and the terms of that contract govern redemption,⁹³⁴ as one recent case brings out. In *Terrell v. Lomas & Nettleton Financial Corp.*⁹³⁵ a debenture holder brought action against the issuer claiming he had not been given reasonable notice of redemption and was therefore damaged by being deprived of the opportunity to convert his debentures into common shares and make a profit thereon. More specifically, he claimed that notice of the redemption should have been mailed to him at his residence in Houston or by published notice in a Houston newspaper. Under the terms which appeared on the debenture, notice of the redemption was to be published twice in an "Authorized Newspaper" and sent by mail to each registered owner. It also provided that all debentures would have to be re-registered on or after December 1, 1960, or else become transferable by bearer. Plaintiff, who had acquired his debentures in July 1960, did not re-register them and as a consequence did not receive the notice sent to holders who had registered their debentures after the December 1, 1960, date. The court held that the debentures were a form of contract whose explicit terms were clear and unambiguous insofar as notice was concerned; thus, there was no implied duty to give any other form of notice than was actually given to holders who had not complied with the re-registration process.⁹³⁶ There being no duty owed and no duty breached⁹³⁷ and the re-registration require-

ston 1918); *McCoy v. Bankers Trust Co.*, 200 S.W. 1138, 1141 (Tex. Civ. App.—Dallas 1918), *error ref.*; *cf.* *World Oil Co. v. Hicks*, 19 S.W.2d 605, 612, *aff'd*, 34 S.W.2d 581 (Tex. Comm'n App. 1931), *judgment affirmed*. See generally 11 W. FLETCHER, CYCLOPEDIA CORPORATIONS § 5196; 1, 2 I. HILDEBRAND, THE LAW OF TEXAS CORPORATIONS §§ 257, 283 (1942) [hereinafter cited as I. HILDEBRAND, TEXAS CORPORATIONS]. A few state statutes impliedly recognize the rule by providing that shares are not fully paid until any notes or checks given therefor have been paid. *E.g.*, LA. REV. STAT. § 12:52 (c) (1969); MINN. STAT. § 301.18(3) (1969).

932. TEX. BUS. CORP. ACT ANN. art. 2.14(D) (1956); *cf.* *Smoot v. Perkins*, 195 S.W. 988 (Tex. Civ. App.—Amarillo 1917).

933. TEX. BUS. CORP. ACT ANN. art. 4.08(A) (1956).

934. See, *e.g.*, AMERICAN BAR FOUNDATION, CORPORATE DEBT FINANCING PROJECT, MODEL DEBENTURE INDENTURE PROVISIONS [FOR] ALL REGISTERED ISSUES § 1105 (1967). See generally H. BALLANTINE, CORPORATIONS 497 (rev. ed. 1946) [hereinafter cited as BALLANTINE]; V. BRUDNEY & M. CHIRELSTEIN, CASES & MATERIALS ON CORPORATE FINANCE 176 (1972); W. CARY, CASES AND MATERIALS ON CORPORATIONS 1229, 2162 (4th ed. unabridged, 1969) [hereinafter cited as CARY]; 4 Z. CAVITCH, BUSINESS ORGANIZATIONS § 91.02; 6A W. FLETCHER, CYCLOPEDIA CORPORATIONS § 2731; 19 *id.* §§ 9162-63.

935. 496 S.W.2d 669 (Tex. Civ. App.—Tyler 1973), *error ref. n.r.e.*

936. The corporation published the notice of redemption in the *Wall Street Journal*, the *New York Times*, the *Dallas Morning News*, the *Dallas Times Herald*, and the *American Banker* on seven dates within a span of twenty-four days. 496 S.W.2d at 672.

937. The court followed the ruling of the court of civil appeals for the First District (Houston) in an unreported opinion involving essentially the same facts which it regarded as establishing the controlling law of the case. *Lomas & Nettleton Financial Corp. v. Terrell*, No. 15,895 (Tex. Civ. App.—Houston [1st Dist.] April 13, 1972).

ment not being so unreasonable or unfair as to require it be disregarded, the plaintiff had no basis for his complaint.⁹³⁸

B. *Dividends and Other Distributions*

Restrictions on Surplus. Under the TBCA cash or property dividends are payable only out of the unreserved and *unrestricted* earned surplus of the corporation;⁹³⁹ if the corporation has no earned surplus, arrearages on preferred can be paid out of *unrestricted* capital surplus.⁹⁴⁰ Similarly, the degree to which a corporation can repurchase its own shares is dependent in most cases on the extent to which *unrestricted* earned, capital or reduction surplus is available therefor.⁹⁴¹ These surplus accounts become restricted, according to article 2.03(E), to the extent any form of surplus is used as the measure of the corporation's right to repurchase its shares, and remain restricted so long as and to the degree the shares are held in the treasury and are not otherwise disposed of or cancelled.⁹⁴² However, because of the manner in which certain financial terms have been defined in the Act, in effect a double restriction was imposed on any surplus account used as the basis for repurchase of shares. This came about by virtue of the definition of surplus to mean the excess of net assets of the corporation over its stated capital⁹⁴³ and a corresponding definition of net assets to mean the amount "by which the total assets of a corporation, *excluding treasury shares*, exceed the total debts of a corporation."⁹⁴⁴ For example, assume that a Texas corporation with total assets of \$300,000, total debts of \$100,000, \$100,000 in stated capital and \$100,000 in earned surplus, decided to repurchase \$30,000 of its own shares. To calculate the amount of surplus the corporation then had, first the \$30,000 had to be subtracted from the total assets, leaving a balance of \$270,000 in total assets. Next the \$100,000 in total debts would be subtracted from that sum, leaving \$170,000 in net assets. The excess of that amount over the stated capital of \$100,000 would then leave a balance of only \$70,000 in earned surplus. But according to article 2.03(E), since earned surplus was used as the measure of the corporation's right to repurchase its shares, it became restricted by \$30,000, thus leaving only \$40,000 in unrestricted earned surplus available for payment of cash or property dividends.

This undoubtedly inadvertent result can be traced back to the Model Act

938. The court indicated that the plaintiff first learned of the redemption when he attempted to collect his coupon which was returned unpaid in June 1969 "which date was too late to redeem his debentures." 496 S.W.2d at 671. This suggests the plaintiff lost all rights to receive the redemptive price of his debentures which of course would have been confiscatory; what was lost was his right to convert them into common stock as shown by his suit which sought to recover the profit he would have made by timely conversion.

939. TEX. BUS. CORP. ACT ANN. art. 2.38(A)(1) (1956).

940. *Id.* art. 2.39(B).

941. *Id.* arts. 2.03(B), (C) (1956), (D) (Supp. 1974).

942. Once any of the treasury shares are disposed of or cancelled, the restriction as to such shares is "removed pro tanto as to all of such restricted surplus not eliminated thereby." *Id.* art. 2.03(E) (1956).

943. *Id.* art. 1.02(A)(12).

944. *Id.* art. 1.02(A)(10) (emphasis added).

source for the TBCA definitions and provisions for repurchase of shares.⁹⁴⁵ The 1950 version of the Model Act sought to eliminate treasury shares in the ultimate calculation of surplus by excluding them from the definition of net assets.⁹⁴⁶ In 1953 the repurchase of shares section was revised to impose the restriction approach⁹⁴⁷ but without changing the net assets definition. Although the consequent double restriction was pointed out in an excellent article on the financial provisions of the Model Act as far back as 1957,⁹⁴⁸ it was not until 1969 that the Model Act's definition of net assets was amended to eliminate the "excluding treasury shares" language,⁹⁴⁹ admittedly to "avoid an unintended duplication of deductions upon the purchase by a corporation of its own shares."⁹⁵⁰ The Texas revisers followed suit and through one of the 1973 amendments have eliminated the troublesome phrase.⁹⁵¹

Dividends. In *Ramo, Inc. v. English* the Texas Supreme Court decided an important case on whether advances made by a subsidiary to its parent corporation can be characterized as loans or dividends.⁹⁵² Briefly, the case arose from a dispute between the sellers (the English family) and the purchaser (Ramo) and its parent (Telecom) of all the shares of stock of a motor freight company (Red Ball). The action had been initiated by Ramo, Telecom, and Red Ball against the sellers seeking a declaratory judgment concerning the terms of the sale and asking for damages for alleged breaches of warranty. The Englishes counterclaimed, alleging that each of twenty-four separate acts of default on the plaintiff's part entitled them to accelerate the

945. The TBCA definitions were taken almost wholly from section 2 of the Model Act. Comment of Bar Committee to Art. 1.02, 3A TEX. REV. CIV. STAT. ANN. 13 (1956). On the other hand, the TBCA provision in article 2.03 on repurchase of shares while derived from section 5 of the Model Act, including the language restricting surplus when shares are repurchased, modified and somewhat expanded upon the section to assure greater protection for corporate creditors. See Bailey, *Safeguarding the Claims of Creditors [Under the Proposed Texas Business Corporation Act]*, 4 BAYLOR L. REV. 470, 483 (1952).

946. ABA MODEL BUS. CORP. ACT § 2 (1950).

947. *Id.* § 5 (rev. ed. 1953).

948. Hackney, *The Financial Provisions of the Model Business Corporation Act*, 70 HARV. L. REV. 1357, 1392 (1957). Professor Hamilton makes note of the same doubling effect in his treatise. 20 R. HAMILTON, TEXAS BUSINESS ORGANIZATIONS § 648, at 113. But see Kessler, *Share Repurchases Under Modern Corporation Laws*, 28 FORDHAM L. REV. 637, 642 n.15 arguing the desirability of the double adverse effect.

949. ABA MODEL BUS. CORP. ACT ANN. 2d, § 2.

950. *Id.* ¶ 2, at 37.

951. Ch. 545, § 1, [1973] Tex. Laws 1486, amending TEX. BUS. CORP. ACT ANN. art. 1.02(A)(10) (Supp. 1974). The Bar Committee explained the reason for the change:

Since according to generally accepted accounting principles treasury shares are not counted in the total assets of a corporation, a specific exclusion is superfluous and confusing, since it may imply an additional deduction upon purchase of treasury shares by a corporation. The amendment makes clear that there is not a deduction from both total assets and 'net assets' upon purchase of treasury shares. Creditors remain protected by the restriction imposed by Art. 2.03 whenever surplus is used to acquire treasury shares.

Comment of Bar Committee to Art. 1.02, 3A TEX. REV. CIV. STAT. ANN. 8 (Supp. 1974).

952. 500 S.W.2d 461 (Tex. 1973). For detailed facts and an analysis of the decision of the Dallas court of civil appeals, see Lebowitz, *Corporations, Annual Survey of Texas Law*, 27 Sw. L.J. 85, 111-12 (1973), discussing *English v. Ramo, Inc.*, 474 S.W.2d 600 (Tex. Civ. App.—Dallas 1971), *rev'd*, 500 S.W.2d 461 (Tex. 1973).

maturity of the purchase money notes executed by Ramo and praying for judgment for the unpaid balance.

The case in both appellate courts turned largely on certain sizeable advances Ramo had had Red Ball make to it after the sale.⁹⁵³ The Englishes claimed that the advances contravened a covenant by Ramo in a noteholders' security agreement that no cash dividends could be paid out by Red Ball except from profits accruing after the date of the agreement or that would reduce the continuing capital and surplus of Red Ball below their aggregated amount as of a specified date. The trial court awarded judgment to the purchasers, denying the Englishes any recovery on their counterclaim, and disregarding a jury finding relating to the advances that found that each time Red Ball transferred funds to Ramo, the latter had no intention that they be repaid. The Dallas court of civil appeals reversed on this issue, ruling that there was sufficient evidence to support the jury's finding but that regardless the advances constituted dividends as a matter of law in contravention of the terms of the security agreement thereby permitting acceleration. Its rationale was that no notes had been given for or interest paid on the supposed loans, that Ramo's use of Red Ball's funds without paying it interest had conferred a substantial economic benefit upon it that was equivalent to a dividend, and "that regardless of the form of the transaction, a distribution of corporate funds to a controlling stockholder because of its stock ownership and for its sole benefit, and repayable at its sole discretion, is a dividend insofar as the rights of creditors are concerned."⁹⁵⁴ The court basically felt the purpose of the dividend limitation in the security agreement was to prevent Red Ball's financial position from being weakened while the notes remained unpaid, as happened because of the advances,⁹⁵⁵ and should not be circumvented by terming the withdrawals loans.

The supreme court reversed. It agreed with the Dallas court that a distribution of money or property to shareholders can constitute a dividend as a matter of law even though it is not formally declared or designated as such by the directors.⁹⁵⁶ But as it read the record, the evidence did not establish as a matter of law that the advances in question were dividends rather than loans, although conceding the facts relied on by the Dallas court were "rather persuasive."⁹⁵⁷ The high court looked instead to other facts such as a recital

953. The sale was consummated on June 21, 1968. From the period of June 24, 1968, to October 1, 1969, Red Ball made cash advances to Ramo totalling \$2,272,357.81, including an initial advance of \$1,500,000 made right after the sale. 500 S.W.2d at 462, 464.

954. 474 S.W.2d at 605.

955. In early 1970 Red Ball had to borrow \$450,000 from two banks, paying interest at 9½% per annum, and from September 1969 to March 1970 it also borrowed a total of \$1,425,000 from Telecom, evidenced by notes bearing interest ranging from 8½% to 9½%. 500 S.W.2d at 465.

956. This accords with the general American rule. *See, e.g.,* Metropolitan Trust Co. v. Becklenberg, 300 Ill. App. 453, 21 N.E.2d 152, 155 (1939); Grants Pass Hardware Co. v. Calvert, 71 Ore. 103, 142 P. 569, 574 (1914); Sunseri v. Sunseri, 358 Pa. 1, 55 A.2d 370 (1947); *cf.* Tweedie Footwear Corp. v. Fonville, 115 S.W.2d 421 (Tex. Civ. App.—Dallas 1938), *error ref.* *See generally, e.g.,* CARY 1565; 11 W. FLETCHER, CYCLOPEDIA CORPORATIONS § 5350; D. KEHL, CORPORATE DIVIDENDS 155, 278 (1941); 2 MO. L. REV. 223 (1937).

957. 500 S.W.2d at 466.

in Red Ball's minutes that the largest advance to Ramo of 1.5 million dollars was to be a loan,⁹⁵⁸ the entries on the books of Red Ball and Ramo that termed the withdrawals "advance receivable" and "advance payable to subsidiary," respectively, and the repayment of some of the advances and the execution of notes in Red Ball's favor just before the trial.⁹⁵⁹ Moreover, and perhaps decisively, it was impressed with the fact that while the two principal members of the English family had been in control of Red Ball they, too, had caused it to make advances to themselves without interest and evidenced only by entries on the books and that were not repaid until the night of the sale.⁹⁶⁰ As to the Dallas court's basic ruling, quoted above, that a loan in form can be treated as a dividend in substance when designed to circumvent a limitation on dividend payments, the supreme court construed this as a holding "that the advances are dividends within the meaning of the security agreement even though they may be loans in the sense that Ramo was legally obligated to repay on demand."⁹⁶¹ As thus reformulated the Dallas court's holding contravened a basic rule relating to an acceleration clause, namely that it should be strictly construed because of its harshness and that if any reasonable doubt arises concerning its terms, it must be interpreted in a way that avoids forfeiture and acceleration.⁹⁶² Here, as the high court saw it, there was nothing to indicate that the parties intended the word "dividends" to have any meaning other than its usual and ordinary usage. They made no attempt to limit Red Ball's right to make loans to shareholders or to regulate the terms and interest rate of any that might be made. Having first-hand knowledge of their own withdrawals and advances, the two principal sellers could have readily included a provision in the agreement to prohibit loans to Ramo if they had wished that form of protection. But the agreement spoke only of dividends and the term could not be given a broader meaning to permit acceleration of maturity. Hence, if Ramo were legally obligated to repay the advances, they could not be dividends within the meaning of the security agreement as a matter of law.

As to the jury finding, it was immaterial whether Ramo intended to repay the advances or not. If the transactions were bona fide loans and Ramo was

958. The minutes stated, in part, the announcement by the chairman that the next order of business was to cause Red Ball to loan Ramo \$1,500,000, and that a motion was duly made, seconded, and unanimously adopted resolving "that the corporation loan to Ramo, Inc., on an open account payable on demand, the sum of \$1,500,000." *Id.* at 464.

959. On April 15, 1970, shortly before the trial, Telecom advanced \$1,400,000 to Ramo which paid that amount to Red Ball on the advances. But this turned out to be largely a bookkeeping transaction as Red Ball then used the proceeds to pay the \$1,425,000 obligation it had to Telecom. *Id.* at 465.

960. By the time of the sale the unpaid balance on the advances made by Red Ball to H.E. English and O.B. English amounted to \$1,684,359.69 which was repaid to Red Ball the night of the sale, presumably out of the \$4,000,000 down payment on the total purchase price for Red Ball and its two wholly-owned subsidiaries of \$15,500,000. *Id.* at 466.

961. *Id.*

962. The court approved the approach and manner in which the rule was stated in *Motor & Indus. Fin. Corp. v. Hughes*, 157 Tex. 276, 289, 302 S.W.2d 386, 394 (1957), and *Crumley v. Ramsey*, 93 S.W.2d 191, 192-93 (Tex. Civ. App.—Waco 1936), *error ref.*

legally obligated to repay them, their legal effect would not be altered by its intent not to repay.⁹⁶³ There was, however, a fact issue raised as to the genuine nature of the transactions as loans or dividends which could have been resolved by the submission of an issue inquiring whether there was a subterfuge in the manner in which the loans were handled or that would let the jury, upon proper instructions, decide if the advances were loans or dividends. Unfortunately from the Englishes' standpoint, no such issue was requested or given and thus they were deemed to have waived this independent ground of recovery.

In summary, the essence of the supreme court's holding seems to be that had the issue concerning the nature of the advances been properly submitted to the jury and had it found they were dividends and not loans, there was sufficient evidence to have supported its finding. But granting the issue may not have been submitted in its ultimate terms, it is difficult to see why a finding that there was no intent to repay is not material in concluding what legal effect is to be given to the parties' intentions and actions. This is especially true since the critical question in characterizing a withdrawal of corporate funds by shareholders as loan or dividend is whether there was any intent to repay at the time of the withdrawal.⁹⁶⁴ To say that if Ramo were legally obligated to repay the advances they were loans and not dividends is to beg the question, since, as the high court acknowledges, this is the basic difference between the two.⁹⁶⁵ What must be done is to examine the facts adduced by the evidence to determine if the disputed transaction has the elements of one or the other and then determine its legal consequences. On that score, the Dallas court's reading of the facts and its conclusion that the advances to Ramo although loans in form were constructive dividends seem sounder.

963. The court speculated that perhaps Ramo intended to cancel the indebtedness after the English notes had been paid and released, but that even if it did, this was not enough to convert the advances into dividends within the meaning of the security agreement. 500 S.W.2d at 467.

964. A number of tax cases dealing with the issue of whether advances to shareholders are dividends rather than loans have held that the subjective intent of the parties is the essential factor and that for a transaction to constitute a loan, intent that the monies advanced be repaid must be apparent. *E.g.*, *Bayou Verret Land Co. v. Commissioner*, 450 F.2d 850, 859 (5th Cir. 1971); *Ogden Co. v. Commissioner*, 412 F.2d 223, 225 (1st Cir. 1969) (advances to parent by wholly-owned subsidiary); *Commissioner v. Makransky*, 321 F.2d 598, 600 (3d Cir. 1963); *Oyster Shell Prods. Corp. v. Commissioner*, 313 F.2d 449, 452 (2d Cir. 1963); *Spheeris v. Commissioner*, 284 F.2d 928, 931 (7th Cir. 1960), *cert. denied*, 366 U.S. 944 (1961); *Tirza A. Cox*, 56 T.C. 1270 (1971) (payment by one affiliated corporation to another to discharge bank loan of controlling shareholder); *Charles A. Sammons*, P-H Tax Ct. Mem. ¶ 71,145 (1971) (advance between affiliated corporations benefitting controlling shareholders). See generally B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 7.05 (3d ed. 1971); J. CHOMMIE, *LAW OF FEDERAL INCOME TAXATION* § 182 (1968); I J. MERTENS, *LAW OF FEDERAL INCOME TAXATION* § 9.07 (rev. repl. 1971); Bradford, *The Constructive Receipt of Dividends by Stockholders of Closely Held Corporations*, 47 KY. L.J. 17, 378 (1958-59); Comment, *Disguised Dividends: A Comprehensive Survey*, 3 U.C.L.A.L. REV. 207 (1956). For non-tax cases recognizing intent as a determinative element, see, *e.g.*, *Smith v. Moore*, 199 F. 689, 697 (9th Cir. 1912) (withdrawals by principal stockholder carried on books as debit items); *Oilwell Chem. & Materials Co. v. Petroleum Supply Co.*, 64 Cal. App. 2d 367, 148 P.2d 720 (1944); *Central of Ga. Ry. v. Central Trust Co.*, 135 Ga. 472, 69 S.E. 708, 719 (1910). See generally BALLANTINE § 239.

965. 500 S.W.2d at 465.

C. Repurchase of Shares

Legislative Changes. The right of the corporation to acquire its shares by purchase was affected by two of the 1973 amendments. The first relates to the authorization required when a corporation desires to use unrestricted capital or reduction surplus as a basis for the repurchase of shares.⁹⁶⁶ Heretofore such repurchase has required approval by the board of directors and by the holders of two-thirds of each class of voting shares.⁹⁶⁷ As amended, the class voting requirement has been eliminated so that approval by the holders of two-thirds of all the voting shares outstanding will suffice; moreover, the articles may provide for approval of this and other actions by the vote of the holders of an even lesser number of shares if no less than a majority or more.⁹⁶⁸ In addition, action by the shareholders may be dispensed with entirely if the articles so provide.⁹⁶⁹ Finally, the authorization applies to either a direct or indirect repurchase of shares.⁹⁷⁰

The wisdom of these changes is somewhat dubious. The removal of the class voting requirement removes a safeguard which preferred or other senior classes of equity securities may have had to preclude the diminution of the cushion represented by the capital surplus realized by the amount in excess of par value paid for common shares,⁹⁷¹ or through a reduction of the stated capital contributed by such shares.⁹⁷² However, arguably even under the former law, preferred would likely not have had the right to vote on the matter or else could have protected itself against such contingency in the preferred share contract and for that matter still can.⁹⁷³ And while allowing the articles to deprive the shareholders of any vote at all on the matter undoubtedly expands the discretionary powers of management as to reacquisition of shares, the potential abuses of the repurchase power because of its selectivity, as contrasted to the uniformity of distribution of dividends,⁹⁷⁴ weigh heavily in favor of requiring shareholder approval. This is especially true when no earned surplus is available to use as a basis for the repurchase. On the other hand, since the directors are already permitted to make distributions in partial liquidation and to pay off arrearages in preferred from capital

966. Ch. 545, § 4, [1973] Tex. Laws 1488, amending TEX. BUS. CORP. ACT ANN. art. 2.03(D) (Supp. 1974).

967. Ch. 64, § 2, [1955] Tex. Laws 244.

968. TEX. BUS. CORP. ACT ANN. art. 9.08 (Supp. 1974); see discussion in text accompanying notes 28-36 *supra*.

969. *Id.* art. 2.03(D); see Comment of Bar Committee to Art. 2.03, 3A TEX. REV. CIV. STAT. ANN. 28 (Supp. 1974); Doty & Parker 1013.

970. TEX. BUS. CORP. ACT ANN. art. 2.03(D) (Supp. 1974).

971. *Id.* arts. 2.17(A), (B) (1956).

972. *E.g.*, by an amendment to the articles of incorporation decreasing the number of outstanding shares or by reducing their par value, *Id.* arts. 4.03(B)(4), (5), or in the case of shares without par value, by a statement filed with the secretary of state reducing stated capital as to that part represented by such shares. *Id.* art. 4.12. See 20 R. HAMILTON, TEXAS BUSINESS ORGANIZATIONS § 875.

973. See, *e.g.*, CARY 1254; Buxbaum, *Preferred Stock—Law and Draftmanship*, 42 CALIF. L. REV. 243, 255, 290 (1954); Israels, *Limitations on the Corporate Purchase of Its Own Shares*, 22 SW. L.J. 755, 756 (1968).

974. *Cf.* TEX. BUS. CORP. ACT ANN. art. 2.38(A) (1956). "Dividends among stockholders of the same class must always be pro rata, equal, and without discrimination or preference." 11 W. FLETCHER, CYCLOPEDIA CORPORATIONS § 5352, at 723.

surplus without need for shareholder approval,⁹⁷⁵ perhaps they should be given comparable authority with respect to repurchases. But at a minimum, if the articles do not permit the safeguards of either class or shareholder voting, there should be the same requirement for repurchases measured by capital or reduction surplus as there is for repurchases made to the extent of earned surplus available therefor, *i.e.*, that accrued preferential dividends shall have been fully paid first.⁹⁷⁶

The second amendment will have even greater impact because it prohibits a corporation not only from purchasing but also from making payment either directly or indirectly for shares when there is reasonable ground for believing the corporation is or would become insolvent by such purchase or payment, or if after the purchase or payment the fair value of the total assets will be less than the total amount of debts.⁹⁷⁷ By adding the word "payment" throughout the section, the amendment makes clear that insolvency either in the equity or bankruptcy sense⁹⁷⁸ will cut off any attempted distribution of corporate assets to the selling shareholder to the detriment of creditors. This applies even though the original commitment to purchase the shares may have been lawful at the time it was made because the requisite surplus was available.⁹⁷⁹ In this regard, it should be noted that "payment" was not added

975. TEX. BUS. CORP. ACT ANN. arts. 2.40(A), (B) (1956).

976. *Id.* art. 2.03(C).

977. Ch. 545, § 5, [1973] Tex. Laws 1488, amending TEX. BUS. CORP. ACT ANN. art. 2.03(F) (1956).

978. "[I]nsolvency in the equity sense has always meant an inability of the debtor to pay his debts as they mature. Under the Bankruptcy Act it means an insufficiency of assets at a fair valuation to pay the debts." *Finn v. Meighan*, 325 U.S. 300, 303 (1945) (Douglas, J.). See 20 R. HAMILTON, TEXAS BUSINESS ORGANIZATIONS § 618, at 79. The question has been asked why Texas uses insolvency in both senses; while a corporation with surplus can be insolvent in the equity sense, how can it then have a surplus if it is insolvent in the bankruptcy sense? Hartmann & Wilson, *Payment For Repurchased Shares Under the Texas Business Corporation Act*, 26 Sw. L.J. 725, 731 n.20 (1972). An answer is that it cannot, but that is not the end of the matter because even though there is no surplus, stated capital can be used for repurchases to eliminate fractional shares, collect or compromise corporate indebtedness, pay off dissenting shareholders, or to effect the redemption or repurchase of redeemable shares. TEX. BUS. CORP. ACT ANN. art. 2.03(B) (1956). Thus even though a capital deficit results from such repurchases, the corporation still might be able to pay its debts as they become due and hence not be insolvent in an equity sense. Use of the bankruptcy test as well assures that the fair value of assets will not be reduced below the total amount of debts whether immediately due or not. Cf. Kessler, *supra* note 948, at 666 n.93.

979. If reduction surplus is used as the basis for repurchase of shares when the corporation is insolvent, then even before the amendment directors who voted for or assented to a payment "out of" reduction surplus to repurchase shares became liable to the corporation or a receiver or trustee in bankruptcy for the amount paid out in order to discharge the claims of specified creditors, but only to the extent their claims were not otherwise satisfied out of corporate assets. TEX. BUS. CORP. ACT ANN. art. 2.41(A) (6) (1956). A director held to such liability would then be entitled to contribution from any shareholder who received any such payment out of reduction surplus. *Id.* The liability provision was inserted into the TBCA to protect creditors and prevent abuses caused by creating reduction surplus and then using it to make distributions in partial liquidation or to repurchase shares. Bailey, *supra* note 945, at 486. Arguably, even if reduction surplus were used to justify the payment for a repurchase of shares, article 2.41(A)(6) does not apply since technically when shares are repurchased, the normal accounting entry is to credit cash and debit treasury shares. Unless the shares acquired are immediately cancelled, the reduction surplus account is not diminished although it becomes restricted to the extent of the repurchase by virtue of article 2.03(E). See Hackney, *supra* note 948, at 1392 n.166. But given the need for protection of creditors when distributions of corporate assets are made to shareholders at a time of insolvency

to the surplus requirements of sections B, C and D of article 2.03. Thus, the test of the validity of a *purchase* of shares is still to be resolved initially on the basis of both the needed capital or surplus therefor as well as for solvency, whereas the test for *payment* for repurchased shares is to be determined solely on the basis of solvency in both senses of the word. Put another way, if a solvent corporation had the proper capital or surplus on hand at the time of repurchase, payment can be made at a later time without any surplus, provided the corporation is not then insolvent or would be made so by payment for the shares.⁹⁸⁰

The new amendment corresponds to a similar change made in the Model Act in 1956⁹⁸¹ and should go far both in resolving some problems with respect to the former law discussed recently at some length in this *Journal*⁹⁸² and those raised by the three recent cases discussed below, particularly *Williams v. Nevelow*.⁹⁸³ Until the *Williams* case, the Texas courts had not addressed themselves to the issue of whether the surplus cutoff test prescribed in the TBCA for repurchases of shares also applied when deferred or installment payments were being later made and it was evident the corporation did not then have the needed surplus.⁹⁸⁴ Nor was the law elsewhere very clear.⁹⁸⁵ Prior to the adoption of modern corporation statutes embodying a surplus or some other definable test for determining the validity of share repurchases, the courts, if recognizing the right of the corporation to repurchase shares at all,⁹⁸⁶ used a standard of "no prejudice to the rights of creditors"

in either of its two accepted forms, it is doubtful a court would be deterred from imposing liability under article 2.41(A)(6) because of a semantic difference.

980. See Hartmann & Wilson, *supra* note 978, at 734; Herwitz, *Installment Repurchase of Stock: Surplus Limitations*, 79 HARV. L. REV. 303, 322 (1965).

981. Then section 5 (now section 6) of the Model Act, dealing with acquisition and disposition of a corporation's own shares, was revised in 1956 to include the "purchase or payment" terminology. MODEL BUSINESS CORPORATION ACT 1957 ADDENDUM ¶ 4; 1 ABA MODEL BUS. CORP. ACT ANN. § 5 (1960).

982. See Hartmann & Wilson, *supra* note 978.

983. 501 S.W.2d 942 (Tex. Civ. App.—San Antonio 1973), *rev'd*, 513 S.W.2d 535 (Tex. 1974), *discussed in text* accompanying notes 1006-21 *infra*.

984. One federal judge had expressed himself on the matter. *Palmer v. Justice*, 322 F. Supp. 893 (N.D. Tex.) (Taylor, J.), *aff'd per curiam*, 451 F.2d 371 (5th Cir. 1971); *see discussion in text* accompanying notes 996-1002 *infra*.

985. Hartmann & Wilson, *supra* note 978, at 731; Herwitz, *supra* note 980, at 311.

986. Most American courts recognized the right of a corporation to repurchase its shares even in the absence of statutory authorization which is now common, but a few followed the English rule enunciated in *Trevor v. Whitworth*, 12 App. Cas. 409 (H.L. 1887), forbidding such purchases either under the common law or because deemed forbidden by other legislation. *E.g.*, *Latulippe v. New England Inv. Co.*, 77 N.H. 31, 86 A. 361, 362 (1913); *Darnell-Love Lumber Co. v. Wiggs*, 144 Tenn. 113, 230 S.W. 391, 393 (1921); *Pace v. Pace Bros.*, 91 Utah 132, 59 P.2d 1, 8 (1936). *See generally* BALANTINE 604; Cary 1593; 6A W. FLETCHER, CYCLOPEDIA CORPORATIONS §§ 2824-26; 1 G. HORNSTEIN, CORPORATION LAW AND PRACTICE §§ 112, 491 (1959) [hereinafter cited as HORNSTEIN]; Dodd, *Purchase and Redemption by a Corporation of Its Own Shares*, 89 U. PA. L. REV. 697 (1941); Levy, *Purchase by an English Company of Its Own Shares*, 79 U. PA. L. REV. 45 (1930); Nemmers, *The Power of A Corporation to Purchase Its Own Stock*, 1942 Wis. L. REV. 161; Wormser, *The Power of a Corporation to Acquire Its Own Stock*, 24 YALE L.J. 177 (1915). Although prior to adoption of the TBCA, there was no Texas statute specifically permitting repurchase of shares, Texas cases followed the majority American rule. *E.g.*, *Koch v. Val Verde Mercantile Corp.*, 4 S.W.2d 662, 664 (Tex. Civ. App.—San Antonio 1928); *San Antonio Hardware Co. v. Sanger*, 151 S.W. 1104, 1105 (Tex. Civ. App.—San Antonio 1912), *error ref.*; *Howe Grain & Mercantile Co. v. Jones*, 51 S.W. 24, 26 (Tex. Civ. App. 1899). *See generally* 1 I. HILDEBRAND, TEXAS CORPORATIONS § 79; Blackstock, *A Corporation's*

or invoked the trust fund doctrine.⁹⁸⁷ This evolved into an insolvency test with much depending on whether the purchase was consummated before or after that status had been reached. As two commentators put it, "if the repurchase preceded insolvency, the transaction was lawful, while if repurchase followed insolvency, it was illegal."⁹⁸⁸ Additional difficulties arose when deferred payments were involved, with the question then becoming whether insolvency was to be tested for at the time the repurchase contract was made or when payments were due. The majority view was expressed in a Fifth Circuit decision, *Robinson v. Wangemann*,⁹⁸⁹ an often-cited holding and as indicated below, used as the basis for decisions of the lower courts in the *Williams* case.⁹⁹⁰ The court in *Robinson* rationalized that because the corporation received nothing of real value when it reacquired its shares, anything later paid for them in cash or other assets involved a distribution to shareholders that would harm creditors if the corporation were then insolvent. As quoted by the court of civil appeals in *Williams*:

In principle, the contract between [the shareholders] and the corporation was executory until the stock should be paid for in cash. *It is immaterial that the corporation was solvent and had sufficient surplus to make payment when the agreement was entered into. It is necessary to a recovery that the corporation should be solvent and have sufficient surplus to prevent injury to creditors when the payment is actually made.* This was an implied condition in the original note and renewals accepted by [the shareholder].⁹⁹¹

The minority rule was exemplified in *Wolff v. Heidritter Lumber Co.*,⁹⁹² a New Jersey decision, where the court considered the choice of payment for the stock in either cash or by an obligation payable in the future one the corporation could legitimately make if solvent at the time of the purchase and not acting in disregard of the equitable rights of other shareholders. If it elected the obligation route, the selling shareholder became a creditor who would rank equally with other creditors.⁹⁹³

The advent of modern statutes such as the Model Act adopting primarily a combined surplus and insolvency test to determine the legitimacy of stock repurchases failed to resolve the issue because some courts then used both

Power to Purchase Its Own Stock and Some Related Problems, 13 TEXAS L. REV. 442 (1935).

987. See Dodd, *supra* note 986, at 701; Hartmann & Wilson, *supra* note 978, at 727; Herwitz, *supra* note 980, at 305; Note, *Stock Repurchase Abuses and the No Prejudice Rule*, 59 YALE L.J. 1177 (1950).

988. Hartmann & Wilson, *supra* note 978, at 728.

989. 75 F.2d 756 (5th Cir. 1935).

990. *Williams v. Nevelow*, 501 S.W.2d 942 (Tex. Civ. App.—San Antonio 1973), *rev'd*, 513 S.W.2d 535 (Tex. 1974).

991. *Robinson v. Wangemann*, 75 F.2d 756, 757-58 (5th Cir. 1935), *as quoted in Williams v. Nevelow*, 501 S.W.2d 942, 947 (Tex. Civ. App.—San Antonio 1973), *rev'd*, 513 S.W.2d 535 (Tex. 1974) (emphasis added by *Williams* court).

992. 112 N.J. Eq. 34, 163 A. 140 (Ch. 1932).

993. The holding in *Wolff* was seemingly repudiated in *Kleinberg v. Schwartz*, 87 N.J. Super. 216, 208 A.2d 803 (App. Div.), *aff'd on opinion below*, 46 N.J. 2, 214 A.2d 313 (1965), but was revived in a revision of the New Jersey statutes that rejected the *Kleinberg* ruling and reinstated the time of purchase for application of the surplus cutoff test. N.J. REV. STAT. § 14A:7-16(6) (1969) (Commissioner's Comment 1968); see CARY 1603.

standards to question the validity of installment or deferred payments even though the original purchase had been properly made.⁹⁹⁴ But other courts did not. Thus in *Tracy v. Perkins-Tracy Printing Co.*⁹⁹⁵ the Minnesota Supreme Court permitted enforcement of chattel mortgages executed to secure a corporation's promissory note given to pay for its shares when it had adequate surplus on hand, ruling that the liens created by the mortgages were not affected by the subsequent depletion of corporate surplus. More significantly, in *Palmer v. Justice*, the federal decision referred to earlier,⁹⁹⁶ the court considered the application of the TBCA to a similar situation when at the time the shares in question were repurchased the corporation had ample earned and capital surpluses to cover the transaction but not when the promissory note given in consideration was paid three years later. The court indicated by way of dictum that the term "purchase" used in article 2.03 refers to the time the agreement is entered into but not when payment is made,⁹⁹⁷ but found for the selling shareholders in an action brought by the corporation's trustee in bankruptcy to recover the note payment on the ground that there was neither statutory liability under article 2.41⁹⁹⁸ nor common law liability under the trust fund doctrine.⁹⁹⁹ It also distinguished the *Robinson* case because there the obligation under attack had not yet been paid when filed as a claim in the corporation's bankruptcy proceeding whereas in its case the repayment had occurred almost two-and-a-half years prior to the filing of bankruptcy by the corporation. The Fifth Circuit affirmed in a curious per curiam decision¹⁰⁰⁰ saying that it was not necessary to consider whether the corporation had to have sufficient unrestricted surplus at the time the actual payment was made, because the shares were repurchased to compromise an indebtedness owed by or to the corporation as expressly authorized by ar-

994. See, e.g., *Mountain State Steel Foundries, Inc. v. Commissioner*, 284 F.2d 737, 742 (4th Cir. 1960); *In re Mathews Constr. Co.*, 120 F. Supp. 818, 821 (S.D. Cal. 1954); *Cutter Labs, Inc. v. Twining*, 221 Cal. App. 2d 302, 313-14, 34 Cal. Rptr. 317, 323-24 (1963); *Burk v. Cooperative Fin. Corp.*, 62 Wash. 2d 740, 384 P.2d 618, 625 (1963). See also *Hartmann & Wilson*, *supra* note 978, at 731-32; *Herwitz*, *supra* note 980, at 311.

995. 278 Minn. 159, 153 N.W.2d 241 (1967).

996. See note 984 *supra*.

997. 322 F. Supp. at 894.

998. The court reasoned that TBCA art. 2.41(A)(6), imposing liability on the directors for payments out of reduction surplus as the purchase price of shares, did not apply because at the time of payment there was no showing the corporation was insolvent either before or after the repurchase, as required by that provision. Nor could liability be imposed under TBCA art. 2.41(E), giving a director against whom a claim is asserted by that article a right of contribution from a shareholder who receives a dividend "or other distribution of assets," since, assuming the quoted phrase included payments made to repurchase shares, no showing was made that the shareholders who received the distribution knew its payment was illegal, as required by the subsection. 322 F. Supp. at 895-96.

999. Application of the trust fund doctrine in Texas is dependent on two conditions: (1) the corporation's insolvency, and (2) its cessation of doing business. See text accompanying, and authorities cited in, note 869 *supra*. In the court's view both of these conditions applied to any attempt to recover illegal dividends or other distributions, as indicated in *Temple Lumber Co. v. Pineland Naval Stores Co.*, 25 S.W.2d 675, 677 (Tex. Civ. App.—Beaumont 1930), since the TBCA does not cover the matter specifically, agreeing on this point with *Lebowitz, Duties and Liabilities of Directors*, in *TEXAS BUSINESS CORPORATION ACT INSTITUTE PROCEEDINGS* 67, 91 (1955), reprinted in 3A *TEX. REV. CIV. STAT. ANN.* 500, 521 (1956). 322 F. Supp. at 896.

1000. 451 F.2d 371 (5th Cir. 1971).

ticle 2.03(B)(2)¹⁰⁰¹ "and there the matter ends."¹⁰⁰² Given the court's position in the judicial hierarchy, no one would quarrel that that is where the matter stood as far as the parties were concerned. The difficulty is that the court's pronouncement is a non sequitur because in all the cases in point the initial purchase could equally have been said to have been authorized under statutory solvency or stated capital or surplus standards.

It is against this background then that the reasons for the 1973 amendment must be evaluated and its impact on the recent cases discussed next must be considered. As the Bar Committee sees it, the "amendment assures that the insolvency limitation is applied both at the time of purchase *and* at the time of payment" but does not purport to affect the surplus restriction which applies only at the date of purchase.¹⁰⁰³ But despite this effort at clarification, one nagging doubt remains. Suppose the corporation gives a valid secured promissory note in payment for its shares when adequate surplus is available but at the time the note must be paid it has become insolvent. Arguably, any attempt to satisfy the note out of corporate assets at that time would be an indirect payment for the shares at a time of insolvency and consequently prohibited by amended article 2.03(F). But is giving a secured negotiable instrument "payment" for the shares so that at the time they were purchased they were fully paid for in the sense that "value" has been given for them? The Texas Supreme Court has dropped a tantalizing hint this may be so¹⁰⁰⁴ and for that reason has suggested that "[i]n view of the historical judicial prohibition against enforcement of otherwise unconditional promises of payment after the time of insolvency, it would be well for the Legislature to settle the question expressly."¹⁰⁰⁵ Hopefully the Bar Committee at least will consider the court's suggestion.

1001. The subsection cited allows a corporation by act of its board of directors to repurchase its shares to the extent of the aggregate of any available unrestricted surplus and its stated capital to collect or compromise any debt owed by or to the corporation. TEX. BUS. CORP. ACT ANN. art. 2.03(B)(2) (1956). Insufficient facts were stated, however, to know the nature of the debt being collected or under what other circumstances the shares in question were repurchased.

1002. 451 F.2d at 371.

1003. Comment of Bar Committee to Art. 2.03, 3A TEX. REV. CIV. STAT. ANN. 28 (Supp. 1974).

1004. In reversing the San Antonio court of civil appeal's decision in *Williams v. Nevelow*, 501 S.W.2d 942 (Tex. Civ. App.—San Antonio 1973), the supreme court noted the distinction now made between purchase and payment by the 1973 amendment, but then added: "It does not necessarily follow that a different result would be reached in the present case if the amended language of the statute with reference to solvency of the corporation were applicable. The issuance of a secured negotiable instrument could be considered 'payment' for the repurchased stock." 513 S.W.2d 535, 539 (Tex. 1974), citing *Hartmann & Wilson, supra* note 978, at 735, wherein the authors argue that decisions (such as those of the lower courts in *Williams*) that hold that repurchase contracts are executory until cash is actually paid overlook the fact that a negotiable promissory note constitutes "payment" under the Texas Uniform Commercial Code in that "value" is transferred to the selling shareholder by the corporation's issuance of the note. TEX. BUS. & COMM. CODE ANN. § 1.201(44) (1968).

1005. 513 S.W.2d at 539. One legislative solution might be that used by New Jersey in restoring application of the surplus cutoff test at the time shares are repurchased, *see* note 993 *supra*, by providing: "A corporation which has purchased its own shares out of surplus may defer payment for such shares over such period as may be agreed between it and the selling shareholder. The obligation so created shall constitute an ordinary debt of the corporation and the validity of any payment made upon the debt so created shall not be affected by the absence of surplus at the time of such payment." N.J. REV. STAT. § 14A:7-16(6) (1969).

Case Law Developments. Three recent cases dealt with the validity of corporate reacquisition of shares with the most important being *Williams v. Nevelow*,¹⁰⁰⁶ discussed in part above, primarily because of the reasons given for its reversal by the Texas Supreme Court.

In *Williams* the trustee in bankruptcy of Highway Drilling Company, Inc. brought an action to set aside a foreclosure of a security agreement between Highway and its former sole shareholder, Williams. The agreement covered virtually all of the equipment and personal property of Highway and had been given to secure its note in payment for the repurchase of 1,164 of its shares. The note and agreement were part of a larger transaction whereby Williams' son and two others bought the remainder of his stock by giving him their own promissory note as consideration, secured by a pledge of the shares. Both notes were monthly installment notes except that Highway's installment payments covered interest only and its note could not be prepaid until the individuals' note had been paid in full; moreover, any default in payments on their note would cause acceleration of maturity of Highway's note at Williams' option. In addition, Williams received all the accounts receivable but agreed to pay all of Highway's debts other than its note to him. A year after Williams sold out he foreclosed on the secured property after defaults in payments on the notes and his learning that Highway was on the verge of bankruptcy. He bought in the property sold for \$20,000, claiming it was not worth more although Highway's records indicated the value was much greater. Shortly thereafter Highway voluntarily entered into bankruptcy; this action was ultimately brought by the trustee, resulting in a judgment setting the foreclosure sale aside, largely on the authority of the *Robinson* case.¹⁰⁰⁷

On appeal to the San Antonio court of civil appeals, Williams contended that (1) at the time of the transaction Highway had over \$140,000 in unrestricted earned surplus which was more than sufficient to authorize the purchase of his shares under article 2.03, (2) all existing creditors had been paid, (3) all creditors represented by the trustee were subsequent creditors after he sold out, and (4) there were no pleadings or evidence of fraud. The trustee countered that the effect of the two transactions was to tie up all of Highway's assets which were used to secure the personal purchase of its stock by its new owners and to help precipitate its ultimate insolvency and bankruptcy. The trustee's basic contention, however, was that the case was controlled by *Robinson*.

The San Antonio court agreed. As it saw it, the crucial question was whether Highway's solvency was to be tested at the time the note and security agreement were given or when the foreclosure was held. The answer under the *Robinson* rationale was that it did not matter if creditors became such before or after the date of the purchase; the crucial time was when payment

1006. 501 S.W.2d 942 (Tex. Civ. App.—San Antonio 1973), *rev'd*, 513 S.W.2d 535 (Tex. 1974).

1007. Under the trial court's findings of fact and conclusions of law, summarized in the court of civil appeals opinion at 501 S.W.2d 944 n.1, the trial court concluded that because the corporation was insolvent at the time of foreclosure, a fact known to Williams, payments made pursuant to the foreclosure sale were void as to corporate creditors and therefore the bill of sale to Williams should be set aside and all assets returned to the trustee in bankruptcy, citing *Robinson v. Wangemann*, 75 F.2d 756 (5th Cir. 1935).

was to be made and the corporate assets taken out. It conceded that if Highway had bought and paid for the stock at the time of the exchange, the transaction would be valid against all creditors. "However, *when actual payment for the stock is to be made at some future time*, the creditors who became such subsequent to the agreement may complain if payment is to be made while the corporation has no *earned surplus*, is insolvent, or if such payment would render the corporation insolvent."¹⁰⁰⁸ As to the TBCA, the court quoted sections A and B of article 2.03, finding that the purchase did not fall within any of the four authorized categories listed in section B permitting a repurchase to the extent of unrestricted surplus and stated capital for limited purposes.¹⁰⁰⁹ The only other provision of article 2.03 mentioned was the pre-1973 amendment insolvency cutoff in section F which was summarized in a footnote without comment.¹⁰¹⁰ Quite obviously, the transaction was not one falling within article 2.03(B); under the facts given section C permitting repurchase to the extent of unrestricted earned surplus clearly applied. Yet inexplicably and despite its pertinency, the court did not mention section C at all. Instead reference was made to a 1917 federal case listing some of the considerations courts take into account in condemning or sustaining the repurchase of shares,¹⁰¹¹ most of which were inapposite in view of the more pertinent statutory standards. It finally concluded that the trial court properly determined the case was controlled by the *Robinson* rationale. One point worth noting is the court's assumption that the surplus cutoff test as well as the insolvency rule applies at the time of payment even though the surplus test had been satisfied when the purchase was made. This seems contrary to the use of "purchase" in article 2.03 before its amendment, but in this regard the court has respectable company, as noted earlier.¹⁰¹²

At first when *Williams* was appealed to the supreme court, it refused to grant the writ of error for no reversible error,¹⁰¹³ but after considering a motion for rehearing on the application, agreed to hear the case. After stating the facts, the court reviewed the development of the repurchase doctrine in relation to deferred payments or use of the corporation's promissory note, taking due note of the *Robinson* holding relied on by the lower courts. It read *Robinson* as preventing the corporation from making a valid transfer of assets to reacquire its shares unless at the time of the transfer the solvency and the surplus of the corporation would not be impaired. But assuming *Robinson*

1008. 501 S.W.2d at 947 (emphasis added).

1009. Section B permits repurchases by action of the directors to the extent of any available unrestricted surplus and stated capital to eliminate fractional shares, collect or compromise indebtedness owed to or by the corporation, pay dissenting shareholders, or effect the purchase or redemption of redeemable shares. TEX. BUS. CORP. ACT ANN. art. 2.03(B) (1956).

1010. 501 S.W.2d at 948 n.7.

1011. *Sanford v. First Nat'l Bank*, 238 F. 298, 302 (8th Cir. 1917). Among the considerations listed, in addition to insolvency, were whether there had been an intent to defraud present or future creditors by the repurchase, were any such creditors thus injured and if so, was the repurchase the real cause for their not being paid. Interestingly, the court in that case rebuffed an attempt by the trustee in bankruptcy to recover funds paid by the corporation on promissory notes it had given to repurchase shares when it was shown that it had been solvent at all times when payments on the notes were made.

1012. See authorities cited in note 994 *supra*.

1013. 17 Tex. Sup. Ct. J. 140 (1974).

to have been the Texas rule, the enactment of the TBCA in 1955 produced a different rule in the court's judgment. It then set out and analyzed sections A, C, E and F of article 2.03, emphasizing the language in section C permitting the corporation to repurchase shares to the extent of the unrestricted earned surplus available *at the time of the purchase*. The court concluded, "Thus the validity of the transaction and the authority of the corporation to repurchase its shares are determined *at the time of the purchase, and the statute places no restriction upon the transfer of cash or assets at a subsequent date.*"¹⁰¹⁴

In the high court's view, Highway "purchased" its stock at the time of the initial transaction. The term "purchase" means the voluntary transfer of property from one person to another for valuable consideration,¹⁰¹⁵ which includes an unconditional exchange of a promissory note for stock.¹⁰¹⁶ It does not mean the act whereby the buyer finally parts with tangible property, as the *Robinson* rationale suggests. This interpretation it felt was reinforced by section E that restricts surplus to the extent it is used to permit the repurchase of shares, since the restriction endures only until the shares have been disposed of, and not when a promissory note for which they were acquired was paid off. Although acknowledging some courts have re-read the common law rule as to repurchases into statutes such as the Model Act, the court read the TBCA to require a contrary result, citing in support the *Palmer*¹⁰¹⁷ and *Tracy*¹⁰¹⁸ cases referred to earlier. It also noted the 1973 amendment to section F as recognition of the difference between "payment" and "purchase." Finally, it raised the question concerning insolvency at the time of payment noted earlier,¹⁰¹⁹ saying but not deciding that a different result would not necessarily have been reached in the case before it had the amendment been in effect, even though Highway was obviously insolvent at the time payment was made through the foreclosure sale. But this remains to be seen. While it is useful for the court to have raised the issue and perhaps inspire a legislative solution, it apparently did not consider the other language added by the 1973 amendment to section F, namely that the corporation shall not pay "directly or indirectly" for shares if insolvent or if insolvency would result.

The supreme court's opinion is clearly the preferable interpretation of article 2.03 in the deferred payment situation and further justifies the change made by the 1973 amendment. Yet there is something disquieting about the net result of the case for it seemingly sanctions a scheme whereby a sole shareholder of a corporation can sell out to others by having the corporation

1014. *Williams v. Nevelow*, 513 S.W.2d 535, 537 (Tex. 1974) (emphasis added).

1015. The court cites *Spur Ind. School Dist. v. W.A. Holt Co.*, 88 S.W.2d 1071, 1073 (Tex. Civ. App.—Waco 1935); *Cobb v. Webb*, 26 Tex. Civ. App. 467, 64 S.W. 792, 793 (1935), *error ref.*

1016. "No statute is known to use the term 'purchase' to mean the act by which the buyer finally parts with tangible property and not to mean a consummated trade which may be the unconditional exchange of a promissory note for stock. See [TEX. BUS. & COMM. CODE ANN. § 1.201(32) (1968); TEX. TAX-GEN. ANN. art. 20.01(G) (1969)]." 513 S.W.2d at 537-38.

1017. *Palmer v. Justice*, 322 F. Supp. 893 (N.D. Tex. 1971), *aff'd per curiam*, 451 F.2d 371 (5th Cir. 1971); discussed in text accompanying notes 996-1002 *supra*.

1018. *Tracy v. Perkins-Tracy Printing Co.*, 278 Minn. 159, 153 N.W.2d 241 (1967); discussed in text accompanying note 995 *supra*.

1019. See text accompanying notes 1004-05 *supra*.

finance the transaction in part, retain a security interest, and then after a year foreclose and end up with the corporation's assets, while creditors, subsequent ones, true, but undoubtedly some with whom he had dealt while he owned the corporation, are left without any substantial recourse, simply because the corporation had a sufficient balance sheet surplus at the time of the sale.¹⁰²⁰ Perhaps for this reason, the supreme court was careful to note that the TBCA provisions in point do not purport to cover the equitable grounds for setting aside a repurchase transaction but found no bad faith in the case before it.¹⁰²¹

The second case is *Hall v. Hall, Weller, Hall & Jeffery, Inc.*,¹⁰²² previously discussed in part in relation to close corporations. The action was brought by a shareholder and former employee of a professional accounting corporation for specific performance of a stock purchase agreement between the corporation and its shareholders. Under the terms of the agreement the corporation obligated itself to buy back the shares of a shareholder upon his death, disqualification, incapacity, termination of employment, or voluntary retirement from accounting practice with payment to be made by a promissory note payable over a period of years. The contract further provided that to the degree the corporation was prevented by law from making all or any part of the repurchase, the remaining shareholders were to purchase the same. The trial court found that under the contract formula for determining the price of shares, the plaintiff was entitled to be paid \$246,000 for his shares; however, it also found that the corporation only had a stated capital of \$50,000, capital surplus of \$135,000, and approximately \$7,000 in earned surplus. Nevertheless, it ordered the corporation to issue plaintiff a negotiable promissory note for \$246,000 to pay for his shares.

On appeal, the Houston (1st District) court of civil appeals immediately recognized the problem the corporation faced under article 2.03 since it was evident that at most the capital surplus and earned surplus could be used as a measure to test the validity of the repurchase. Apparently an argument was made that under article 2.03(B)(4) the amount in stated capital could also be considered in that redeemable shares were being acquired, but as the court correctly pointed out, shares are redeemable only if they have a liquidation preference,¹⁰²³ which these shares did not. The trial court's judgment clearly would have required the corporation to purchase its own shares in an amount not authorized by the Act and, the court added without explanation, would have also caused it to commit an act forbidden by section F, the provision adopting the insolvency and excess of assets over liabilities cutoffs for

1020. Cf. *Fagan v. La Gloria Oil & Gas Co.*, 494 S.W.2d 624 (Tex. Civ. App.—Houston [14th Dist.] 1973), discussed in text accompanying notes 860-77 *supra*. There the court did not allow technical requirements for invoking the trust fund doctrine to hinder the imposition of liability upon controlling shareholders in a situation where it was obvious a creditor was being defrauded. Perhaps the lower courts in the *Williams* case instinctively felt article 2.03 should be interpreted to attain the same result.

1021. 513 S.W.2d at 538. Regarding equitable limits on the repurchase of shares, see, e.g., 20 R. HAMILTON, TEXAS BUSINESS ORGANIZATIONS § 643; 1 HORNSTEIN § 495; *Israels*, *supra* note 973, at 758.

1022. 497 S.W.2d 374 (Tex. Civ. App.—Houston [1st Dist.] 1973); see text accompanying notes 580-82 *supra*.

1023. TEX. BUS. CORP. ACT ANN. art. 4.09(A) (1956).

repurchases. Since the corporation was to pay for the shares by a long-term promissory note, it is not at all certain the mere giving of the note would have rendered the corporation insolvent in the sense of being unable to pay its debts as they became due in the ordinary course of business;¹⁰²⁴ on the other hand, it is likely that under the figures given the accounting treatment of the promissory note might well have resulted in the fair value of the corporation's assets being less than the total amount of its debts as specified in section F.¹⁰²⁵ At any rate, the parties themselves had contemplated that the corporation might be unable to comply with the repurchase obligation and had therefore committed the remaining shareholders to purchase the stock the corporation could not acquire. The trial court erred in not requiring them to carry out their part of the bargain which the corporation was precluded by law from fulfilling.

In a sense the *Hall* case represents the converse of the problem raised in *Williams* in that at the time of purchase the corporation could not satisfy the surplus test yet it is entirely conceivable that by the time a given installment on the corporation's note was to be paid, it had become solvent and would have an excess of assets over liabilities even after paying the installment.¹⁰²⁶ Of course, if, as indicated by the facts, the corporation could not meet section F's assets standard when the promissory note was to be given and, as suggested by the supreme court in *Williams*,¹⁰²⁷ the issuance of the note would have constituted payment for the shares, the transaction would have definitely been barred under the 1973 amendment to section F as well.

The third decision is a Fifth Circuit case, *Witter v. Triumph Smokes, Inc.*,¹⁰²⁸ involving facts virtually identical to those in *Triumph Smokes, Inc. v. Sarlo*,¹⁰²⁹ a Tyler court of civil appeals decision commented on in some detail in the 1973 Survey.¹⁰³⁰ Essentially the issue raised in both cases concerned the validity of debentures that had been given in exchange for the corporation's shares when the corporation had no earned surplus at the time the exchange was made or later when the debentures matured and were presented for payment. The Fifth Circuit's reasoning is quite similar to that found in the Tyler court's opinion (to which it does not refer)¹⁰³¹ and mainly

1024. *Id.* art. 1.02(A)(16).

1025. *Id.* art. 2.03(F) (Supp. 1974). Presumably the note would have been credited as a note payable of \$246,000 and the treasury shares account debited by the same amount, assuming a cost method of accounting were employed. But since treasury shares are not considered as an asset, but generally a deduction from the capital accounts, it is likely the added liability of \$246,000 plus other liabilities would have exceeded the fair value of the corporation's assets when the note was given. On the legal aspects of accounting for treasury shares transactions, see, e.g., G. HILLS, *THE LAW OF ACCOUNTING* 41 (1954); K. SOLOMON, *LAWYER'S HANDBOOK OF ACCOUNTING THEORY AND PRACTICE* 168 (1971); Hackney, *supra* note 948, at 1392; Katz, *Accounting Problems in Corporate Distributions*, 89 U. PA. L. REV. 764, 779 (1941); Rudolph, *Accounting for Treasury Shares Under the Model Business Corporation Act*, 73 HARV. L. REV. 323 (1959); Sprouse, *Accounting for Treasury Stock Transactions: Prevailing Practices and New Statutory Provisions*, 59 COLUM. L. REV. 882 (1959).

1026. Thus satisfying TEX. BUS. CORP. ACT ANN. art. 2.03(F) (Supp. 1974).

1027. *Williams v. Nevelow*, 513 S.W.2d 535, 539 (Tex. 1974).

1028. 464 F.2d 1078 (5th Cir. 1972) (per curiam).

1029. 482 S.W.2d 696 (Tex. Civ. App.—Tyler 1972), *error ref. n.r.e.*

1030. See Lebowitz, *supra* note 952, at 108.

1031. The Fifth Circuit's decision was reported two months after the Tyler court's; hence it is quite possible neither's opinion was available to the other.

regards the issuance of the debentures under the circumstances as equivalent to an ultra vires act and not an illegal one, even if in violation of article 2.03. The provisions of that article were designed to protect creditors and since there was no allegation that corporate creditors would be adversely affected by paying the debentures and no creditor had sought to intervene, the corporation as in other situations involving limitations on the exercise of corporate power¹⁰³² was estopped to deny their validity. On that basis the opinion certainly squares with Texas authority.¹⁰³³

The issuance of debentures for shares when the corporation is not authorized to reacquire them has raised several interesting questions.¹⁰³⁴ Another may now be asked in light of the amendment of article 2.03(F). Suppose at the time the debentures were issued the corporation had sufficient earned surplus on hand to justify their exchange for its shares but at the time the debentures matured, the provisions of section F could not be satisfied because the corporation had become bankrupt or had been placed in receivership for insolvency.¹⁰³⁵ The question of course is fundamentally the same as that posed by the *Williams* case, except that article 2.03(F) as amended would seem definitely to preclude the debentures from being paid or would certainly require subordination of their payment to claims of other creditors.¹⁰³⁶ In addition, both the Fifth Circuit and the Tyler court indicated that if creditors rights were involved, the outcome would be different.¹⁰³⁷ But both opinions also suggest that even if insolvent, the corporation would still be estopped to prevent their payment if no creditor had complained even under the changed language in section F.

VII. OTHER DEVELOPMENTS

A. Additional Statutory Changes

Dissolution. The only changes made in the statutes dealing with voluntary dissolution were elimination of the two-year period within which incorporators could dissolve a corporation that had not commenced business after its certificate of incorporation had been issued¹⁰³⁸ and to give the directors as well

1032. *E.g.*, *Whitten v. Republic Nat'l Bank*, 397 S.W.2d 415 (Tex. 1965) (statutory prohibition of loans to directors and officers only a limit on corporate powers and does not make loan to president illegal). *See generally* 19 R. HAMILTON, TEXAS BUSINESS ORGANIZATIONS § 361.

1033. *E.g.*, *Triumph Smokes v. Sarlo*, 482 S.W.2d 696 (Tex. Civ. App.—Tyler 1972), *error ref. n.r.e.*, discussed in *Lebowitz*, *supra* note 952, at 108; *Lanpar Co. v. Stull*, 405 S.W.2d 235 (Tex. Civ. App.—Waco 1966), discussed in *Pelletier, Corporations, Annual Survey of Texas Law*, 21 Sw. L.J. 134, 152 (1967).

1034. *See Lebowitz*, *supra* note 952, at 110.

1035. *Cf.* TEX. BUS. CORP. ACT ANN. art. 7.02(A)(2) (Supp. 1974).

1036. *E.g.*, *McConnell v. Estate of Butler*, 402 F.2d 362, 367 (9th Cir. 1968); *In re Trimble Co.*, 339 F.2d 838, 845 (3d Cir. 1964); *In re Fechheimer Fishel Co.*, 212 F. 357, 363 (2d Cir.), *cert. denied*, 234 U.S. 760 (1914); *In re Belmetals Mfg. Co.*, 299 F. Supp. 1290, 1296 (N.D. Cal. 1969); *In re Dawson Bros. Constr. Co.*, 218 F. Supp. 411, 413 (N.D.N.Y. 1963); *cf.* *La Voy Supply Co. v. Young*, 84 Idaho 120, 369 P.2d 45 (1962). *See generally* 7 Z. CAVITCH, *supra* note 934, § 148.05(2); 1 HORNSTEIN § 496, at 622; *Blackstock*, *supra* note 986, at 447.

1037. *Witter v. Triumph Smokes, Inc.*, 464 F.2d 1078, 1080 (5th Cir. 1972); *Triumph Smokes, Inc. v. Sarlo*, 482 S.W.2d 696, 698 (Tex. Civ. App.—Tyler 1972), *error ref. n.r.e.*

1038. Ch. 545, § 38, [1973] Tex. Laws 1509, amending TEX. BUS. CORP. ACT ANN.

as the incorporators the power to initiate the dissolution.¹⁰³⁹ The latter proviso is consistent with the pattern of other of the 1973 amendments which expand the powers of the first board of directors and correspondingly minimize the role of the incorporators.¹⁰⁴⁰ Another, more general, amendment that will have more impact is the authorization now given to include a provision in the articles of incorporation that allows dissolution or certain other corporate actions requiring shareholder approval to be approved by a vote of the holders of less than two-thirds of the shares outstanding or of each class of shares entitled to vote thereon if a majority or more.¹⁰⁴¹ As to involuntary dissolution, note should again be taken of the amendment added to article 7.01 as part of the Penal Code revision. The attorney general is now authorized to bring an action for involuntary dissolution when a corporation or a high managerial agent in the conduct of its affairs has been convicted of a felony if it can be proven that either has engaged in a persistent course of felonious conduct and dissolution is required to prevent future felonious conduct of the same character.¹⁰⁴²

Foreign Corporations. There have been both statutory and case law developments relating to foreign corporations which are worthy of mention. Nearly all of the cases dealt with issues of jurisdiction or venue and since those of importance have been commented on by others as part of the annual survey,¹⁰⁴³ they will not be treated here.

art. 6.01 (Supp. 1974). In the opinion of the Bar Committee the two-year limitation was unnecessary as it seemed to serve no useful function. Comment of Bar Committee to Art. 6.01, 3A TEX. REV. CIV. STAT. ANN. 148 (Supp. 1974). Another impetus for the change was the deletion of the two-year period from section 82 of the Model Act which, as section 75 of the Act's 1953 revision, served as the source for article 6.01. ABA MODEL BUS. CORP. ACT ANN. 2d, § 82, Comment (1960).

1039. TEX. BUS. CORP. ACT ANN. art. 6.01 (Supp. 1974). Since the first board of directors is named in the articles of incorporation, *id.* art. 3.02(A)(12), it of course can function prior to the commencement of business, see, *e.g.*, *id.* art. 3.06. However, in giving the directors as well as the incorporators the power to dissolve, not all the provisions of article 6.01 were conformed to reflect the change. Thus, subsection (1)(g) calls for a recitation in the articles of dissolution that "a majority of the incorporators elect that the corporation be dissolved," which suggests that if they are persons other than the directors, they must consent to the dissolution, certainly a result not intended. Similarly, subsection (3) states that the secretary of state is to deliver the certificate of dissolution and duplicate original of the articles of dissolution to "the incorporators or their representatives." The Bar Committee intends to seek correction of these obvious oversights as part of its 1975 legislative proposals.

1040. See discussion in text accompanying notes 69-76 *supra*.

1041. TEX. BUS. CORP. ACT ANN. art. 9.09 (1956); see discussion in text accompanying notes 28-36 *supra*.

1042. Ch. 399, § 2(K), [1973] Tex. Laws 989, adding TEX. BUS. CORP. ACT ANN. arts. 7.01(F), (G) (Supp. 1974), effective January 1, 1974. Comparable provisions were added to TBCA article 8.16 to permit revocation of a foreign corporation's certificate of authority on the same grounds. Ch. 399, § 2(L), [1973] Tex. Laws 989, adding TEX. BUS. CORP. ACT ANN. arts. 8.16(F), (G) (Supp. 1974). See discussion in text accompanying notes 172-75 *supra*. See generally Bubany, *The Texas Penal Code of 1974, Annual Survey of Texas Law*, 28 Sw. L.J. 292, 309 (1974).

1043. *E.g.*, *Frito-Lay, Inc. v. Procter & Gamble Co.*, 364 F. Supp. 243 (N.D. Tex. 1973), discussed in Baade, *Conflict of Laws, Annual Survey of Texas Law*, 28 Sw. L.J. 166, 174 (1974) [cited hereinafter in this note as Baade], and in Figari, *Texas Civil Procedure, Annual Survey of Texas Law*, 28 Sw. L.J. 248, 249 (1974); *Tabulating Systems & Serv., Inc. v. I.O.A. Data Corp.*, 498 S.W.2d 690 (Tex. Civ. App.—Corpus Christi 1973), discussed in Baade at 170; *Dorsid Trading Co. v. Du-Wald Steel Co.*, 492 S.W.2d 379 (Texas Civ. App.—Houston [14th Dist.] 1973), discussed in Baade at 169; *PPG Industries, Inc. v. Continental Oil Co.*, 492 S.W.2d 297 (Tex. Civ. App.—Houston [1st Dist.] 1973), error ref. *n.r.e.*, discussed in Baade at 178; *Humble Oil &*

Duration of Certificate of Authority. Until eliminated by one of the 1973 amendments,¹⁰⁴⁴ a foreign corporation that had been granted a certificate of authority to transact business in Texas had to renew its certificate every ten years. Texas seems to have been alone among the states in limiting a foreign corporation's admission to a specific term.¹⁰⁴⁵ The limitation on duration reflected a policy of long standing¹⁰⁴⁶ and was carried forward into the TBCA when originally enacted, probably to make its adoption more palatable politically. But in light of the grant of perpetual existence to domestic corporations¹⁰⁴⁷ and the more receptive and sympathetic policy towards qualified foreign corporations, enabling them to enjoy the same rights and privileges as domestic corporations,¹⁰⁴⁸ the modification was long overdue.

Change of Name. Another amendment adds a new article to the Act that replaces one repealed in 1967.¹⁰⁴⁹ Taken verbatim from the Model Act,¹⁰⁵⁰ the amendment applies to the situation that occurs whenever a qualified foreign corporation changes its name to one that would not have been granted when the application was made, primarily because it is the same as or is deceptively similar to the name of a domestic or another qualified foreign corporation or that has been reserved or registered.¹⁰⁵¹ Under the amendment, the certificate of authority of the foreign corporation will be suspended until it has changed to a name available to it under Texas law or has otherwise complied with the Act.¹⁰⁵² Although a qualified foreign corporation that has changed its name is required to procure an amendment of its certificate of authority,¹⁰⁵³ the only sanction previously attached for noncompliance was revocation of its authority to do business in Texas by order of the secretary of state for failing to file its change of name within thirty days or because the newly adopted name is one not available for use in Texas.¹⁰⁵⁴ There are several alternatives a foreign corporation whose new name cannot be used

Ref. Co. v. Preston, 487 S.W.2d 956 (Tex. Civ. App.—Beaumont 1972), *error dismissed, cert. granted sub nom. Exxon Corp. v. Preston*, 94 S. Ct. 538, 38 L. Ed. 2d 328 (1973) (No. 73-232), *judgment vacated*, 94 S. Ct. 1394, 39 L. Ed. 2d 459 (1974) (suggestion of mootness), *discussed in* Baade at 225.

1044. Ch. 545, § 42, [1973] Tex. Laws 1510, *amending* TEX. BUS. CORP. ACT ANN. art. 8.07 (Supp. 1974).

1045. See ABA MODEL BUS. CORP. ACT ANN. 2d, §§ 110-12, ¶¶ 3.02, .03 (1960).

1046. the ten-year limitation on a foreign corporation's permit to do business in Texas was first enacted in 1889. Ch. 78, § 6, [1889] Tex. Laws 88, 9 H. GAMMEL, LAWS OF TEXAS 1115-16 (1898). At the time the TBCA was adopted in 1955, it was part of TEX. REV. CIV. STAT. ANN. art. 1529 (1945), *repealed by* ch. 229, § 1, [1961] Tex. Laws 461.

1047. TEX. BUS. CORP. ACT ANN. art. 2.02(A)(1) (1956).

1048. *Id.* art. 8.02.

1049. As enacted in 1955, article 8.04 required a qualified foreign corporation that had determined to change its name to apply to the secretary of state 120 days before the change was to take place for a reservation of the name for use in Texas. This, however, conflicted with article 2.06(A)(4) which makes the reservation of the new name before a change is consummated permissive. To resolve the conflict, article 8.04 was repealed in 1967 as one of the Bar Committee's revision proposals. Ch. 657, § 20, [1967] Tex. Laws 1729; see Amsler, *Proposed Amendments Texas Business Corporation Act*, 29 TEX. B.J. 1013, 1014 (1966).

1050. ABA MODEL BUS. CORP. ACT ANN. 2d, § 109 (1960).

1051. See TEX. BUS. CORP. ACT ANN. art. 8.03(A)(2) (Supp. 1974).

1052. Ch. 545, § 39, [1973] Tex. Laws 1509, *adding* TEX. BUS. CORP. ACT ANN. art. 8.04 (Supp. 1974).

1053. TEX. BUS. CORP. ACT ANN. art. 8.13(A) (1956).

1054. *Id.* art. 8.16(B)(4) (Supp. 1974).

per se can follow. If the name is deceptively similar, it may, for example, obtain the consent of the person or corporation having the name deemed similar¹⁰⁵⁵ or else file an assumed name certificate¹⁰⁵⁶ and conduct business in Texas under a fictitious name.¹⁰⁵⁷ If despite these alternatives, the foreign corporation persists in using its changed name impermissibly, it deserves to have its authority to do business in Texas suspended.

Service of Process. Until 1973, Texas had six statutes that dealt generally with some form of direct or constructive service of process on foreign corporations. Two could be found in the TBCA and Texas Non-Profit Corporation Act respectively and permitted service on the president, all vice-presidents, and the registered agent of a foreign corporation authorized to transact business in Texas or if service could not be had on the registered agent, then on the secretary of state.¹⁰⁵⁸ The other four were part of the general civil statutes. Articles 2031 and 2031-1¹⁰⁵⁹ allowed service on the president, vice-president, secretary, treasurer, general manager, or any local or traveling agent or traveling salesman.¹⁰⁶⁰ Article 2031a prohibited the transaction of business in Texas without filing a power of attorney designating a service agent; permitted constructive service on the secretary of state if the agent could not be found or was not appointed or maintained; and penalized a failure to designate or maintain such service agent by (1) voiding all acts done within the state, (2) precluding the maintenance of any suit, and (3) assessing a fine of \$200 for each month in violation.¹⁰⁶¹ Finally, article 2031b, the Texas "long-arm" statute, in general made the secretary of state the agent for service of process for foreign corporations or other nonresident entities or individuals who are required to designate a service agent but do not, or when the latter cannot be found, or who have transacted "business" in Texas. "Business" is defined to include entering into a contract by mail or otherwise with a resident of Texas to be performed in whole or in part here or the

1055. *Id.* art. 8.03(A)(2).

1056. *Id.* art. 2.05(B) (1956); *id.* art. 8.03(A)(2) (Supp. 1974). Under the latter provision, if the foreign corporation's name is not legally available the corporation may still obtain a certificate of authority to do business in Texas if it files an assumed name certificate with the secretary of state and county clerk as provided in TEX. REV. CIV. STAT. ANN. art. 5924.1 (Supp. 1974), but business can only be transacted in Texas under the assumed name. Interestingly, the Texas assumed name law states specifically it does not apply to either domestic or qualified foreign corporations, TEX. REV. CIV. STAT. ANN. arts. 5927 (1962), 5927a (Supp. 1974), but presumably the TBCA provisions as a later enactment will prevail.

1057. See generally 19, 20 R. HAMILTON, TEXAS BUSINESS ORGANIZATIONS §§ 69, 975-76; H. KENDRICK & J. KENDRICK, TEXAS TRANSACTION GUIDE § 29.23 (1972); Pelletier, *Incorporation Planning in Texas*, in INCORPORATION PLANNING IN TEXAS 5 (G. Pelletier ed. 1973).

1058. TEX. BUS. CORP. ACT ANN. art. 8.10 (1956); TEX. REV. CIV. STAT. ANN. art. 1396-8.09 (1962).

1059. Art. 2031-1 was enacted in 1935 as part of a bill that amended article 2031 to be certain that it applied to any suit then pending or thereafter brought in Texas against a foreign corporation or other entity and to remove a restriction on service on local or travelling salesmen limiting such service to actions arising within the state. It provided that nothing in article 2031 as amended was to be construed to repeal any other law dealing with service of process on foreign corporations but rather was to be regarded as cumulative of such legislation. Ch. 431, §§ 1-2, [1935] Tex. Laws 2d Called Session 1688.

1060. Ch. 431, § 1, [1935] Tex. Laws 1688.

1061. Ch. 376, § 1, [1943] Tex. Laws 674.

commission of any tort in whole or in part in Texas.¹⁰⁶² Moreover, even if the foreign corporation or nonresident was not required to designate or maintain a service agent but nevertheless transacted business in Texas, service could also be had on the person in charge of such business if the action arose therefrom.¹⁰⁶³

Needless to say, the existence of numerous, somewhat overlapping statutes on the same subject left considerable doubt as to their interrelationship and the extent of their application to foreign corporations, particularly in regard to the harsh sanctions imposed by article 2031a.¹⁰⁶⁴ Some clarification, however, came from the courts. For example, the TBCA and Non-Profit Corporation Act provisions are limited by their terms to corporations that have been authorized to transact business in Texas.¹⁰⁶⁵ Although neither act expressly states the mode of service it prescribes is exclusive, the Non-Profit Act does exclude article 2031a from its application,¹⁰⁶⁶ and the TBCA has been held to prescribe the only method for obtaining service on a qualified foreign corporation, preempting articles 2031 and 2031a.¹⁰⁶⁷ There has been no such holding with regard to article 2031b. However, the latter statute does not seem to conflict with either act since all three laws provide for constructive service on the secretary of state alone if service cannot be had on the registered agent of a qualified foreign corporation. As to non-qualified foreign corporations, presumably the more general service statutes applied, although commentators¹⁰⁶⁸ and at least one decision¹⁰⁶⁹ suggested that if such corporations transacted business in Texas when qualification was required, they should be subject to the sanctions against bringing suit spelled out in TBCA article 8.18¹⁰⁷⁰ rather than the more onerous penalties prescribed in article

1062. Ch. 43, §§ 1-7, [1959] Tex. Laws 85. In general on the Texas long-arm statute, see 2 R. McDONALD, *TEXAS CIVIL PRACTICE* §§ 9.29.5, 9.29.6 (rev. repl. 1970); Thode, *In Personam Jurisdiction; Article 2031b, the Texas "Long Arm" Jurisdiction Statute; and the Appearance to Challenge Jurisdiction in Texas and Elsewhere*, 42 TEXAS L. REV. 279, 297-310 (1964); Comment, *Jurisdiction Over Foreign Corporations Under Article 2031b*, 39 TEXAS L. REV. 214 (1960).

1063. Ch. 43, § 2, [1959] Tex. Laws 85.

1064. See, e.g., Shepherd, *Foreign Corporations Doing Business in Texas*, in TEXAS BUSINESS CORPORATION ACT INSTITUTE PROCEEDINGS 35, 47 (1955), reprinted in 3A TEX. REV. CIV. STAT. ANN. 473, 484 (1956); Garwood, *Some Effects of a Foreign Corporation Qualifying or Failing To Qualify To Do Business in Texas*, 26 TEX. B.J. 845, 848 (1963).

1065. TEX. BUS. CORP. ACT ANN. art. 8.10 (1956); TEX. REV. CIV. STAT. ANN. art. 1396-8.09 (1962).

1066. TEX. REV. CIV. STAT. ANN. art. 1396-8.09(D) (1962).

1067. *Investors Diversified Serv., Inc. v. Bruner*, 366 S.W.2d 810, 812 (Tex. Civ. App.—Houston 1963), *error ref. n.r.e.*; cf. *Texaco, Inc. v. McEwen*, 356 S.W.2d 809, 813 (Tex. Civ. App.—Dallas 1962), *error ref. n.r.e.* (dictum); Shepherd, *supra* note 1064, at 49, reprinted in 3A TEX. REV. CIV. STAT. ANN. at 473, 485; Garwood, *supra* note 1064, at 851.

1068. See 20 R. HAMILTON, *TEXAS BUSINESS ORGANIZATIONS* § 987, at 482; Shepherd, *supra* note 1064, reprinted in 3A TEX. REV. CIV. STAT. ANN. at 851.

1069. See *State v. Cook United, Inc.*, 463 S.W.2d 509, 514 (Tex. Civ. App.—Fort Worth), *modified on other grounds*, 469 S.W.2d 709 (Tex. 1971).

1070. TEX. BUS. CORP. ACT ANN. art. 8.18 (1956). While the article prohibits the maintenance of a suit by a foreign corporation that has transacted business in Texas necessitating qualification but without obtaining a certificate of authority, the corporation may defend any action brought against it in the courts of Texas; moreover, failure to obtain the certificate will not impair the validity of any contract or act done within the state. On the other hand, the non-qualified corporation may become liable to the state for the franchise taxes and fees it should have paid and for additional penalties

2031a. On the other hand, articles 2031 and 2031a have been held to govern service of process on foreign insurance companies because the TBCA generally does not apply to such entities.¹⁰⁷¹

The impetus to do something about this less than satisfactory state of the law came when the Bar Committee considered amending TBCA article 8.10 to add a proviso taken from the Model Act¹⁰⁷² that nothing contained in the article "shall limit or affect the right to serve any process, notice, or demand required or permitted by law to be served upon a foreign corporation in any other manner now or hereafter permitted by law."¹⁰⁷³ The Bar Committee was concerned that if passed, the amendment might be construed to have reinstated applicability of articles 2031 and 2031a even to qualified foreign corporations despite the earlier case holdings to the contrary. Thus service might again be permissible on general managers, travelling salesmen, or local agents under article 2031. More seriously, the sanctions imposed by article 2031a, especially in purporting to void all acts performed by a foreign corporation prior to compliance, could well be restored to full vigor despite their incompatibility with the more permissive philosophy of the Act. Moreover, both statutes had been enacted in an earlier era before the Supreme Court had expanded the dimensions of judicial jurisdiction,¹⁰⁷⁴ whereas article

of \$100-\$5,000 for each month it has operated in the state without a certificate. See generally 20 R. HAMILTON, TEXAS BUSINESS ORGANIZATIONS §§ 987-88.

1071. *Bankers Life & Cas. Co. v. Watson*, 436 S.W.2d 404, 406 (Tex. Civ. App.—Tyler 1968), *error ref. n.r.e.* The court held that because TBCA art. 9.14(A) excludes insurance companies from the TBCA's application, the TBCA's service of process provisions could not be employed for insurance companies operating under Texas laws. However, the same section provides that if the special statutes governing excluded corporations do not deal with the matters prescribed by the TBCA, the latter then supplements the special statutes to the extent not inconsistent with them. In addition, TMCLA art. 1.03 makes the TBCA applicable to any corporation for profit to the extent not inconsistent with a special statute for a particular kind of corporation. TEX. REV. CIV. STAT. ANN. art. 1302-1.03(A)(1) (1962). The Texas Insurance Code in turn states that the general corporation law applies to insurance companies the Code governs unless inconsistent with its provisions. TEX. INS. CODE ANN. art. 2.18 (1963). It is not clear why the specific service of process provisions of the Insurance Code did not apply, see, e.g., TEX. INS. CODE ANN. arts. 1.14-1, § 4 (Supp. 1974), 3.65 (1963), but assuming they did not, the three statutes first cited would appear to make TBCA article 8.10 applicable, rather than the older statutes relied on by the court, since it was alleged the defendant insurance company had a permit from the secretary of state to conduct business in Texas.

1072. ABA MODEL BUS. CORP. ACT ANN. 2d, § 116, last paragraph.

1073. *Id.* The Model Act provision reflects the prevailing view that where a statute provides for service on a specified agent but does not indicate such mode of service is exclusive, it is regarded as cumulative of other service statutes. The paragraph was included "to prevent any uncertainty in this regard." *Id.*, Comment.

1074. Article 2031 can be traced back to an 1885 enactment, ch. 83, §§ 1, 2, [1885] Tex. Laws 79, 9 H. GAMMEL, LAWS OF TEXAS 699 (1898). Article 2031a became law in 1933. Ch. 202, §§ 1-5, [1933] Tex. Laws 606. The modern landmark case is *International Shoe Co. v. Washington*, 326 U.S. 310 (1945), that adopted essentially a minimum contacts test so long as traditional notions of fair play and substantial justice are not offended. This expanded concept of judicial jurisdiction reached a highwater mark in *McGee v. International Life Ins. Co.*, 355 U.S. 220 (1957), but receded somewhat in *Hanson v. Denckla*, 357 U.S. 235 (1958), in which the Court emphasized the importance of some nexus with the forum state to make the exercise of jurisdiction over the nonresident reasonable. See generally, e.g., A. EHRENZWEIG, TREATISE ON THE CONFLICT OF LAWS § 33 (1962); H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 97 (2d ed. 1970) [hereinafter cited as HENN]; F. JAMES, CIVIL PROCEDURE § 12.8 (1965); G. STUMBERG, PRINCIPLES OF CONFLICT OF LAWS 93-94 (3d ed. 1963); R. WEINTRAUB, COMMENTARY ON THE CONFLICT OF LAWS 86-92

2031b was a modern statute that had been drafted in light of those developments.¹⁰⁷⁵ As a consequence, the Bar Committee determined that if the Model Act proviso was to be added as section D to article 8.10, as it was, articles 2031, 2031-1, and 2031a should be repealed. The proposed amendment and repealer were placed in a separate bill and ultimately passed by the legislature in that form.¹⁰⁷⁶ The result is that there are now but three statutes on service of process that apply to general business or non-profit foreign corporations: TBCA article 8.10 and Non-Profit Corporation Act article 8.09 for qualified foreign corporations, and article 2031b, the long-arm statute, for use against either foreign corporations that should have qualified to transact business and should have designated a registered agent but have not or those whose activities within the state do not require qualification¹⁰⁷⁷ but have nevertheless transacted some business in Texas.

Despite the needed house cleaning, one problem remains. Article 2031b as presently enacted appears to limit jurisdiction over a foreign corporation not required to qualify or that does not have a regular place of business or service agent in the state to actions arising out of the transaction of business in Texas. This may represent a considered judgment by Texas that it does not desire to expand its judicial jurisdiction to its utmost constitutional bounds even though sufficient activities are conducted to constitute a generally affiliating basis therefor.¹⁰⁷⁸ On the other hand, since the repealed statutes con-

(1971); 4 C. WRIGHT & A. MILLER, *FEDERAL PRACTICE AND PROCEDURE* §§ 1067-68 (1969).

1075. The Texas long-arm statute is derived substantially in form and content from a nonresident service statute proposed by Professor John R. Wilson of Baylor University. Wilson, *In Personam Jurisdiction Over Non-Residents: An Invitation and a Proposal*, 9 BAYLOR L. REV. 363, 378-79 (1957). See also Thode, *supra* note 1062, at 303-10; Thode, "Long-Arm" Jurisdiction and Special Appearance—A Reply, 28 TEX. B.J. 271, 272 (1965); Wilson, *Jurisdiction Over Non-Residents*, 22 TEX. B.J. 221, 222 (1959); Comment, *supra* note 1062. The federal courts have interpreted article 2031b as extending as far as due process will permit. See, e.g., *Jetco Electronic Indus., Inc. v. Gardiner*, 473 F.2d 1228, 1234 (5th Cir. 1973), discussed in Baade, *supra* note 1043, at 171; *Gurley v. Lindsley*, 459 F.2d 268, 278 (5th Cir. 1972); *Atwood Hatcheries v. Heisdorf & Nelson Farms*, 357 F.2d 847, 852 (5th Cir. 1966); *Reul v. Sahara Hotel*, 372 F. Supp. 995, 997 (S.D. Tex. 1974); *Geodynamics Oil & Gas, Inc. v. U.S. Silver & Mining Corp.*, 358 F. Supp. 1345, 1347 (S.D. Tex. 1973), discussed in Baade, *supra* note 1043, at 169; *Mitsubishi Shoji Kaisha Ltd. v. M/S Galini*, 323 F. Supp. 79, 81 (S.D. Tex. 1971). The Texas courts, however, have taken a somewhat more restrictive view and have required that jurisdiction be based on some purposeful act or transaction consummated in the state and that the cause of action arise from or be connected with such act or transaction. See, e.g., *O'Brien v. Lanpar*, 399 S.W.2d 340, 342 (Tex. 1966); *Tabulating Systems & Serv., Inc. v. I.O.A. Data Corp.*, 498 S.W.2d 690 (Tex. Civ. App.—Corpus Christi 1973), discussed in Baade, *supra* note 1043, at 170; *Sun-X Int'l Co. v. Witt*, 413 S.W.2d 761, 765 (Tex. Civ. App.—Texarkana 1967), error ref. n.r.e. But see *Hoppenfeld v. Crook*, 498 S.W.2d 52, 56 (Tex. Civ. App.—Austin 1973), error ref. n.r.e., discussed in Baade, *supra* note 1043, at 225. See generally 20 R. HAMILTON, *TEXAS BUSINESS ORGANIZATIONS* § 973; 2 R. McDONALD, *supra* note 1062, §§ 9.29.5, 9.29.6; Comment, *How Minimum is Minimum Contact? An Examination of "Long Arm" Jurisdiction*, 9 S. TEX. L.J. 184 (1967).

1076. Ch. 63, §§ 1, 2, [1973] TEX. LAWS 124-25, adding TEX. BUS. CORP. ACT ANN. art. 8.10(D) (Supp. 1974), repealing TEX. REV. CIV. STAT. ANN. arts. 2031, 2031-1, 2031a (1964).

1077. See TEX. BUS. CORP. ACT ANN. art. 8.01(B) (Supp. 1974).

1078. The *Restatement of Conflict of Laws* recognizes a state's power to exercise judicial jurisdiction over a foreign corporation doing business within the state with respect to claims not arising from such business if the business carried on is "so continuous and substantial as to make it reasonable for the state to exercise such jurisdiction." RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 47(2) (1971); see *Perkins v. Benguet*

tained no such limitation¹⁰⁷⁹ nor is it found in the TBCA or Non-Profit Act articles, the resulting hiatus in empowering Texas courts to entertain actions involving non-qualified foreign corporations arising out of their activities elsewhere¹⁰⁸⁰ may have been more a matter of legislative oversight than deliberate policy making. If so, consideration should be given to corrective legislation.

B. Other Decisions

Disregard of the Corporate Entity. The number of cases in which efforts were made to go behind the corporate entity to batter down the buffer of limited liability were not as many as in previous years. Some, involving invocation of the alter ego doctrine to hold managing shareholders personally responsible for corporate transactions, have already been commented upon.¹⁰⁸¹ A few decisions dealing with the parent-subsidiary relationship

Consol. Mining Co., 342 U.S. 437, 447-49 (1952). See generally A. EHRENZWEIG, *supra* note 1074, at 114; F. JAMES, *supra* note 1074, at 640; G. STUMBERG, *supra* note 1074, at 95; R. WEINTRAUB, *supra* note 1074, at 107; C. WRIGHT & A. MILLER, *supra* note 1074, § 1069, at 261; von Mehren & Trautman, *Jurisdiction To Adjudicate: A Suggested Analysis*, 79 HARV. L. REV. 1121, 1141 (1966).

1079. Indeed art. 2031 was amended in 1935 to remove a phrase that limited service on a local or travelling agent or travelling salesman to actions arising within the state. See note 1059 *supra*. Moreover, service on a local agent of a foreign corporation under the statute and its predecessors has been held sufficient to support the exercise of jurisdiction over a transitory action arising outside the state. *E.g.*, Buie v. Chicago, R.I. & P. Ry, 95 Tex. 51, 67, 65 S.W. 27, 32 (1901); El Paso & Sw. Co. v. Chisolm, 180 S.W. 156, 158 (Tex. Civ. App.—El Paso 1915), *error dismissed*; Western Union Tel. Co. v. Shaw, 77 S.W. 433, 435 (Tex. Civ. App. 1903), *error ref.*; see 2 R. McDONALD, *supra* note 1062, § 9.25; Comment, *Service of Process on Foreign Corporations in Texas*, 20 TEXAS L. REV. 91, 93 (1941). On the other hand, although nothing in art. 2031a suggested its scope was confined to service with respect to actions arising from the foreign corporation's activities within the state, see Comment, *supra*, at 95, it was nevertheless held the article could not be employed to exercise jurisdiction with respect to transitory actions occurring in other states and unconnected with business done in Texas. Knobloch v. M.W. Kellogg Co., 154 F.2d 45, 47 (5th Cir. 1946); Stephens v. Richman & Samuels, Inc., 118 F.2d 1011, 1012 (5th Cir.), *cert. denied*, 314 U.S. 651 (1941); see Insurance Co. of North America v. Lone Star Package Car Co., 107 F. Supp. 645, 651 (S.D. Tex. 1952); *cf.* Morris & Co. v. Skandinavia Ins. Co., 279 U.S. 405, 409 (1929); Simon v. Southern Ry., 236 U.S. 115, 130 (1915); Old Wayne Mut. Life Ass'n v. McDonough, 204 U.S. 8, 22 (1907). See also 2 R. McDONALD, *supra* note 1062, § 9.26.4; C. WRIGHT & A. MILLER, *supra* note 1074, § 1067, at 227; Comment, *supra*, at 95.

1080. Nevertheless, given the penchant of the federal courts to regard article 2031b as co-extensive with the due process clause, it is not inconceivable, despite the limiting language of that statute, that if a non-qualified foreign corporation is regarded as having a sufficient continuum of business in Texas either directly or through a wholly owned subsidiary, jurisdiction may yet be asserted as to an out-of-state claim. One recent federal district court has come very close to so holding. See Reul v. Sahara Hotel, 372 F. Supp. 995 (S.D. Tex. 1974), where in a products liability action arising from the explosion of a chlorine tank near a swimming pool in Nevada, jurisdiction was upheld against a California corporation which was a wholly integrated subsidiary of a New York parent corporation qualified to do business in Texas on the ground that the activities performed in Texas by the New York parent were the same as the activities performed in Nevada by the California defendant "and in that sense, the cause of action is connected with the parent's activities in Texas." *Id.* at 1002. *Cf.* Bland v. Kentucky Fried Chicken Corp., 338 F. Supp. 871, 875 (S.D. Tex. 1971), *discussed in* Lebowitz, *supra* note 952, at 89. *But cf.* Turner v. Jack Tar Grand Bahama Ltd., 353 F.2d 954, 956 (5th Cir. 1965); Odom v. Thomas, 338 F. Supp. 877, 879 (S.D. Tex. 1971); Hayes v. Caltex Petroleum Corp., 332 F. Supp. 1205, 1206 (S.D. Tex. 1971). See also Baade, *supra* note 1043, at 168-73.

1081. Pravel, Wilson & Matthews v. Voss, 471 F.2d 1186 (5th Cir. 1973); Simon v. Estate of W.P. Allen, 497 S.W.2d 800 (Tex. Civ. App.—Waco 1973), *error ref. n.r.e.*; Fagan v. La Gloria Oil & Gas Co., 494 S.W.2d 624 (Tex. Civ. App.—Houston

and raising issues concerning judicial jurisdiction over foreign corporations and other conflict of laws problems have been expertly discussed by Professor Hans Baade.¹⁰⁸² Two cases remain that should be noted and both illustrate the enterprise theory advanced some years ago by Professor Berle. Under this theory the courts in recognition of economic reality will sometimes construct a single enterprise from a number of incorporated parts in order to prevent fraud or an inequity or an evasion of statutory or other public policy.¹⁰⁸³

In *Allright Texas, Inc. v. Simons*¹⁰⁸⁴ the plaintiff successfully sued Allright Texas, Inc. and Allright Garage, Inc. to recover losses resulting from the negligence of the defendants' employees in failing to guard against the theft of his car and its contents. The plaintiff had parked his car on a lot operated by Allright Garage but was given a ticket used by the Allright Texas parking lot across the street. On appeal, the defendants argued it was error to enter judgment against both corporations. The evidence showed there were five Allright corporations that had interlocking relationships in the operation of parking lots. One of the five entities handled all the bookkeeping and it or one other Allright company paid all the employees of the five. This, the court ruled, was sufficient to support a finding that the two defendants had been doing business under the same trade name and justified the trial court's looking beyond the corporate form and determining as a matter of law that the relationship in reality between the corporations constituted a single business enterprise.¹⁰⁸⁵

The second case, *Clark's-Gamble, Inc. v. State*,¹⁰⁸⁶ was another in a series involving the same multicorporation discount chain and its efforts to avoid the effects of the Texas law forbidding sales of particular merchandise on consecutive Saturdays and Sundays.¹⁰⁸⁷ As in most of the other cases,¹⁰⁸⁸

[14th Dist.] 1973); see discussion in text accompanying notes 875-86 *supra*; cf. Hoppenfeld v. Crook, 498 S.W.2d 52 (Tex. Civ. App.—Austin 1973), *error ref. n.r.e.* (president of corporation held not subject to jurisdiction of Texas courts although corporation would have been; no effort by plaintiff to seek jurisdiction by piercing corporate veil or holding president as alter ego of corporation), discussed in Baade, *supra* note 1043, at 225.

1082. Dailey v. Transitrone Electronic Corp., 475 F.2d 12 (5th Cir. 1973), discussed in Baade, *supra* note 1043, at 203, 226; San Antonio Tel. Co. v. American Tel. & Tel. Co., 364 F. Supp. 1157 (W.D. Tex. 1973), *aff'd*, 499 F.2d 349 (5th Cir. 1974), discussed in Baade, *supra* note 1043, at 173; Frito-Lay, Inc. v. Procter & Gamble Co., 364 F. Supp. 243 (N.D. Tex. 1973), discussed in Baade, *supra* note 1043, at 174.

1083. See Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343 (1947). See also 19 R. HAMILTON, TEXAS BUSINESS ORGANIZATIONS § 234, at 227; E. LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 212-20 (1936).

1084. 501 S.W.2d 145 (Tex. Civ. App.—Houston [1st Dist.] 1973), *error ref. n.r.e.*

1085. *Accord*, Beneficial Fin. Co. v. Miskell, 424 S.W.2d 482 (Tex. Civ. App.—Austin 1968), *error ref. n.r.e.*; Houston-American Life Ins. Co. v. Tate, 358 S.W.2d 645, 656 (Tex. Civ. App.—Waco 1962); State v. Lone Star Gas Co., 86 S.W.2d 484, 491 (Tex. Civ. App.—Austin 1935), *rev'd on other grounds*, 304 U.S. 224 (1938); see Murphy Bros. Chevrolet Co. v. East Oakland Auto Action, 437 S.W.2d 272, 276 (Tex. Civ. App.—El Paso 1969), *error ref. n.r.e.*; Continental Supply Co. v. Forrest E. Gilmore Co., 55 S.W.2d 622, 628 (Tex. Civ. App.—Amarillo 1932), *error dismissed*. See also Lebowitz, *Corporations, Annual Survey of Texas Law*, 26 SW. L.J. 86, 147 (1972).

1086. 486 S.W.2d 840 (Tex. Civ. App.—Amarillo 1972), *error ref. n.r.e.*

1087. TEX. REV. CIV. STAT. ANN. art. 9001 (Supp. 1974), formerly TEX. PEN. CODE ANN. art. 286a (Supp. 1974), transferred by authority of ch. 399, § 5, [1973] Tex. Laws 995.

1088. State v. Cook United, Inc., 469 S.W.2d 709 (Tex. 1971), *modifying* 463 S.W.2d 509 (Tex. Civ. App.—Fort Worth 1971); State v. Cook United, Inc., 464 S.W.2d 105 (Tex. 1971), *rev'g* 455 S.W.2d 332 (Tex. Civ. App.—Fort Worth 1970); Clark's

one corporation (Clark's) operated the discount store six days a week but on Saturday night leased the premises and sold the inventory to another corporation, appropriately named Sundaco, Inc., that operated the store on Sunday and then at midnight returned premises and unsold inventory back to Clark's. The state brought an action against both to enjoin their violation of the law by operating a retail store seven days a week. The trial court found that Sundaco operated the store on Sunday as the agent or conduit of Clark's, and granted a permanent injunction. On appeal, the Amarillo court of civil appeals reviewed the evidence that showed among other facts that both corporations kept the same hours of operations, signs and price tags remained the same, Sundaco kept its records in the discount store's office, the employees of both had the same pay scales, and money would be loaned to Sundaco from the other's money room to start the Sunday operation. The primary factual distinction between this and the earlier cases was that no employee of either corporation would work for the other on Saturday and Sunday and that there was little overlap between the officers and board of the two corporations, although the president of Sundaco who owned a third of its shares when incorporated was an officer in other corporations affiliated with Clark's. Nevertheless the Amarillo court had no difficulty in upholding the trial court's order on the ground that despite the differences in operation, there could be no doubt the general operation and overall manner of conducting the business was substantially the same as in the other Sundaco cases. Thus, given the admitted purpose for the creation of Sundaco and the close alliance between the companies, including the absence of any arms' length transactions between them, the Sundaco arrangement violated the statute.

Usury. In 1967 the Texas Legislature, pursuant to a constitutional amendment adopted in 1960 that authorized the legislature to classify loans and lenders and define and fix the maximum rates of interest,¹⁰⁸⁹ passed a statute as part of the TMCLA permitting a corporation to agree to pay up to one-and-one-half percent interest per month on any funds it borrowed so long as the principal amount of the obligation was \$5,000 or more.¹⁰⁹⁰ The statute further provides: "*and in such instances*, the claim or defense of usury by such corporation, its successors, guarantors, assigns or anyone on its behalf is prohibited" except as to charitable or religious corporations.¹⁰⁹¹ The emphasized phrase, or rather its omission in a recent decision, has led to some

Texas, Inc. v. Stewart, 466 S.W.2d 354 (Tex. Civ. App.—Waco 1971), *error ref. n.r.e.*, discussed in Lebowitz, *supra* note 1085, at 149; State v. Cook United, Inc., 463 S.W.2d 509 (Tex. Civ. App.—Fort Worth), *aff'd and modified on other grounds*, 469 S.W.2d 709 (Tex. 1971), discussed in Lebowitz, *supra* note 1085, at 165; Sundaco, Inc. v. State, 463 S.W.2d 528 (Tex. Civ. App.—Eastland 1970), *error ref. n.r.e.*, discussed in Lebowitz, *supra* note 1085, at 149; Suttle v. State, 457 S.W.2d 344 (Tex. Civ. App.—Waco 1970); State v. Sundaco, Inc., 445 S.W.2d 606 (Tex. Civ. App.—Eastland 1969), *error ref. n.r.e.*, *appeal dismissed*, 397 U.S. 591 (1970).

1089. TEX. CONST. art. XVI, § 11, as amended Nov. 8, 1960.

1090. Ch. 296, § 1, [1967] Tex. Laws 713, adding TEX. REV. CIV. STAT. ANN. art. 1302-2.09 (Supp. 1974) (Texas Miscellaneous Corporation Laws Act), discussed in Amsler, *Corporations, Annual Survey of Texas Law*, 22 SW. L.J. 59, 68 (1968); Loiseau, *Some Usury Problems in Commercial Lending*, 49 TEXAS L. REV. 419, 438-41 (1971); Comment, *Lender Participation in Borrower's Venture: A Scheme to Receive Usurious Interest*, 8 HOUSTON L. REV. 546, 555, 568-69 (1971).

1091. TEX. REV. CIV. STAT. ANN. art. 1302-2.09 (Supp. 1974) (emphasis added).

confusion, at least by a headnote writer, as to whether a corporate undertaking to pay interest in excess of the permitted one-and-one-half percent per month can be claimed as usurious by a corporation.

The case is *Sud v. Morris*¹⁰⁹² and concerned the sustaining of a plea of abatement in an action brought by Sud to recover double the usurious interest of fifteen percent that he had paid on a promissory note for \$500,000 which he and MPS Production Company had jointly and severally executed. The ground of the plea was that MPS and several other parties named in a letter agreement were necessary parties. The status of MPS was not shown, but assuming it were a corporation, the Beaumont court of civil appeals ruled the effect of TMCLA provision was to deprive it of any cause of action it may have had for usury; for that reason it was not a necessary or indispensable party to the litigation. The court quoted the statement in the statute but failed to include the emphasized phrase "and in such instances."¹⁰⁹³ Presumably it was this omission that led the *South Western Reporter* headnote writer to state flatly that "a corporation has no cause of action for usury."¹⁰⁹⁴ The accuracy of this statement of law would be questionable in any case, since the court at one point stated that if MPS were a corporation, the fifteen percent rate the plaintiff alleged he was required to pay and did pay was legal as to it;¹⁰⁹⁵ hence the court may have been doing no more than ruling that for that reason the corporation had no cause of action for the recovery of usurious interest. But if so, doubt would still remain as to the correctness of such a holding, for it seems to imply that the maximum rate of interest a corporation may pay under the TMCLA is eighteen percent per annum.

The problem is that the TMCLA provision does not speak in terms of eighteen percent per annum but rather of one-and-one-half percent per month.¹⁰⁹⁵ Indeed, since under the facts it appeared that seven-and-one-half percent interest had been paid on the loan in advance, a strong argument could be made that if all the advance interest had been paid at one time, the payment was usurious because the seven-and-one-half percent paid obviously exceeded the one-and-one-half percent monthly ceiling. At least one commentator has observed that because the TMCLA's rate ceiling is expressed in terms of monthly rather than annual interest, the statute makes payment of any front-end charges extremely hazardous.¹⁰⁹⁶ The prescience of this warning has been borne out in a very recent Texas supreme court decision modifying but affirming a court of civil appeal's holding that a corporation *can* recover statutory penalties allowed for usurious interest, thus directly contradicting the notion a corporation has no cause of action for usury.

1092. 492 S.W.2d 335 (Tex. Civ. App.—Beaumont 1973).

1093. "2. Usury [key number] 102(1). A corporation has no cause of action for usury. Vernon's Ann. Civ. St. arts. 1302-2.09, 5069-1.02." *Id.*

1094. *Id.* at 337.

1095. "Notwithstanding any other provision of law, corporations, domestic or foreign, may agree to and stipulate for any rate of interest as such corporation may determine, not to exceed one and one-half percent (1½%) per month, on any bond, note, debt, contract or other obligation of such corporation under which the original principal amount is Five Thousand Dollars (\$5,000) or more . . ." TEX. REV. CIV. STAT. ANN. art. 1302-2.09 (Supp. 1974).

1096. Loiseaux, *supra* note 1090, at 439.

In *W.E. Grace Manufacturing Co. v. Levin*¹⁰⁹⁷ a creditor sued a corporation to recover the balance owing on indebtedness plus actual and exemplary damages for fraud. The corporation counterclaimed to recover statutory penalties for usury, asserting \$500 it had agreed to pay plaintiff as a "handling charge" for an advance of \$18,000 was usurious. The purpose of the advance was to enable defendant to obtain two mills it had sold to a third party whose \$25,000 check in payment would then be turned over to plaintiff to repay the advance and handling charge as well as be applied on a \$10,000 note defendant owed plaintiff. The usury claim was based on the fact that the advance had been repaid twenty-two days later when the third party's check for \$24,750¹⁰⁹⁸ was turned over to plaintiff. This meant the defendant had paid \$500 for the use of \$18,000 for twenty-two days which amounted to more than forty-five percent per annum and thus entitled the defendant corporation to recover under the general usury law not only double the amount of interest, or \$1,000 plus its attorney's fees of \$2,500,¹⁰⁹⁹ but also the \$18,000 principal because the interest paid was more than double the amount allowed by law.¹¹⁰⁰

The trial court denied the counterclaim but was reversed by the Dallas court of civil appeals.¹¹⁰¹ The latter ruled that the proceeds from the third party's check should not all be allocated to principal, as plaintiff contended; instead that part covering the \$500 handling charge, having been intended by the parties to be interest, must be considered as such, and being clearly usurious under the TMCLA, the defendant corporation, or rather by now, its trustee in bankruptcy, should have been allowed to recover the statutory penalties for usury. As to the latter, the plaintiff argued that the statute awarding the penalties applied only to interest greater than the amount charged or allowed "by this Subtitle" (the general usury law),¹¹⁰² and not to interest which exceeded the amount that could be charged corporations under the TMCLA. The court's response¹¹⁰³ was to note that the general usury law also stated that "[a]ll contracts for usury are contrary to public policy and shall be subject to the appropriate penalties prescribed in Article 1.06 of this Subtitle."¹¹⁰⁴ It was clear, therefore, the legislature intended the statutory penalties to govern contracts for a greater amount of interest than

1097. 506 S.W.2d 580 (Tex. 1974), *modifying* *Texas Tool Traders v. W.E. Grace Mfg. Co.*, 488 S.W.2d 498 (Tex. Civ. App.—Dallas 1972).

1098. The third party had deducted \$250 as a 1% discount for cash. 506 S.W.2d at 582-83.

1099. "Any person who contracts for, charges or receives interest which is greater than the amount authorized by this Subtitle, shall forfeit to the obligor twice the amount of interest contracted for, charged or received, and reasonable attorney fees fixed by the court . . ." TEX. REV. CIV. STAT. ANN. art. 5069-1.06(1) (1971).

1100. "Any person who contracts for, charges or receives interest which is in excess of double the amount of interest allowed by this Subtitle shall forfeit as an additional penalty, all principal as well as interest and all other charges and shall pay reasonable attorney fees set by the court . . ." *Id.* art. 5069-1.06(2) (1971).

1101. *Texas Tool Traders v. W.E. Grace Mfg. Co.*, 488 S.W.2d 498 (Tex. Civ. App.—Dallas 1972), *modified in* *W.E. Grace Mfg. Co. v. Levin*, 506 S.W.2d 580 (Tex. 1974).

1102. TEX. REV. CIV. STAT. ANN. arts. 5069-1.01 to 1.06 (1971).

1103. 488 S.W.2d at 502.

1104. *Id.*, citing TEX. REV. CIV. STAT. ANN. art. 5069-1.02 (1971) (emphasis by the court).

allowed corporations under the TMCLA as well as apply to general usurious transactions.¹¹⁰⁵

In modifying, the supreme court did not address itself directly to this analysis but obviously assumed its correctness when it stated: "Texas Tool is a corporation, and corporations are now authorized to stipulate for any rate of interest not in excess of 1½ per cent per month on debts in the original principal amount of \$5,000.00 or more. Art. 1302-2.09 V.A.T.S. The class of persons who may be subjected to penalties for usury have been expanded to include those who contract for usurious interest, and more severe penalties have been prescribed. Art. 5069-1.06, V.A.T.S."¹¹⁰⁶ It also agreed the handling charge should be considered as interest; however, inasmuch as the parties' agreement was in terms of payment by the third party of \$25,000 instead of the \$24,750 check actually received, in its judgment, the \$250 deficiency in the check should be deducted from the \$500 interest charge, meaning that only \$250 had been received as interest on the \$18,000 advance for twenty-two days. This still exceeded the one-and-one-half percent maximum which could be recovered plus the \$2,500 attorney's fees, but did not exceed double the maximum rate so as to require repayment of the principal as well. The court of civil appeal's judgment was thus reduced to \$3,000 and, as modified, affirmed.

As a result of the *Grace* decision, there can be no doubt that a Texas corporation can assert a claim for, and presumably a defense of usury when charged interest in excess of the amount allowed in article 2.06 of the TMCLA. At the same time, it is also evident the courts will assess the validity of the interest paid in terms of the one-and-one-half percent monthly figure rather than the total eighteen percent per annum apparently assumed as proper in *Sud v. Morris*. This re-emphasizes Professor Loiseaux's warnings of the dangers involved in paying "points" or other front-end charges based on the latter assumption. The only solution, if the eighteen percent per annum is the desideratum, and it would seem to be the more expected and conventional method of calculation, is legislative action.¹¹⁰⁷

1105. The court's conclusion would seem to allay the fears expressed by the student writer in Comment, *supra* note 1090, that there is no provision by which a lender who received usurious interest from a corporation could be punished because, as the writer analyzed the statutes, the penalties prescribed in article 5069-1.06 were limited by their terms only to those usurious transactions contravening the articles grouped under its subtitle. 8 HOUSTON L. REV. at 568-69. This of course was the same interpretation urged by plaintiff and rejected by the court. Cf. *Lafferty v. A.E.M. Developers & Builders Co.*, 483 S.W.2d 279 (Tex. Civ. App.—San Antonio 1972), *error ref. n.r.e.*, discussed in Larson, *Commercial Transactions, Annual Survey of Texas Law*, 27 Sw. L.J. 67, 76 (1973), where a corporate borrower paying interest in excess of 20% recovered double the usurious interest plus the principal paid; however, because the defendant had not raised the possible applicability of TMCLA art. 2.09 in either the trial court or appellate court, the court refused to consider the issue on his motion for rehearing.

1106. 506 S.W.2d at 583.

1107. At the time of this writing, the Usury Committee of the Section of Corporation, Banking and Business Law of the State Bar intends to propose an amendment to TMCLA article 2.09 that will substitute 18% per annum for the present 1½% per month formula. It will also seek enactment of a new statute as TEX. REV. CIV. STAT. art. 5069-1.07 that will permit "spreading" or allocating over the term of a loan charges included in the total amount of interest on the loan. The committee feels that while such allocation has previously been permissible under Texas law, the decision in *Southwestern Inv. Co. v. Hockley County Seed & Delinting, Inc.*, 511 S.W.2d 724 (Tex. Civ.

Corporate Purposes: International Trading. In a preceding section of this Article it was noted that one of the 1973 amendments now allows a Texas corporation to state as its purpose the transaction of any or all businesses for which corporations can be incorporated under the TBCA.¹¹⁰⁸ Thus, the Texas law has come almost full circle from the days when corporations were limited to a single purpose that had to be selected from those authorized by law.¹¹⁰⁹ As a consequence, there has been virtually no litigation concerning corporate purposes, especially since 1955 when the TBCA came into force and permitted corporations to adopt almost any number or combination of purposes their organizers desired.¹¹¹⁰ But in a recent Texas federal court decision that arose from a threatened takeover of Texasgulf Inc., through a tender offer made by Canada Development Corporation (CDC), the ghost of the single purpose doctrine materialized in the form of an obscure Texas statute permitting formation of an international trading corporation to become one of the major issues in a bitter court struggle by Texasgulf's management to enjoin CDC's tender offer.¹¹¹¹

In July 1973, CDC, a corporation owned by the Canadian government, made an unexpected tender offer for approximately a third of the stock of Texasgulf, a Texas corporation that had extensive mining operations in Canada. The response by Texasgulf's management was to seek a temporary restraining order which was granted, as well as temporary and permanent injunctive relief against the offer. The basis for the relief sought was an alleged violation of the Williams Act¹¹¹² in failing to disclose, among other mat-

App.—Amarillo 1974), seemingly holds that a lender cannot spread front-end interest charges over the life of a loan, thus allowing a corporate borrower to defend enforcement of the loan for usury and recover statutory penalties. Because the loan had been made prior to enactment of TMCLA art. 2.09, the law in effect at the time was applied, as the court in an earlier opinion had refused to give article 2.09 retroactive effect, see *Hockley County Seed & Delinting, Inc. v. Southwestern Investment Co.*, 476 S.W.2d 38 (Tex. Civ. App.—Amarillo 1971), *error ref. n.r.e.*, discussed in Larson, *supra* note 1105, at 75, and Lebowitz, *supra* note 166, at 120. Memorandum by John A. Barrett, Chairman, Committee on Usury of the Section of Corporation, Banking & Business Law of the State Bar of Texas on Proposed Amendments to Article 5069-1.02 and to Article 1302-2.09, addressed to the Council of the Section of Corporation, Banking & Business Law of the State Bar of Texas, Sept. 10, 1974.

Given the emphasis in both opinions in *W.R. Grace* on testing any interest or other charges paid on the 1½% standard, the committee will no doubt feel even greater urgency in seeking enactment of its proposals.

1108. TEX. BUS. CORP. ACT ANN. art. 3.02(A)(3) (Supp. 1974); see discussion in text accompanying notes 82-89 *supra*.

1109. See note 82 *supra*.

1110. TEX. BUS. CORP. ACT ANN. art. 2.01 (Supp. 1974); see note 84 *supra*.

1111. *Texasgulf, Inc. v. Canada Dev. Corp.*, 366 F. Supp. 374 (S.D. Tex. 1973).

1112. Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454 (codified as 15 U.S.C. §§ 78m(d)-(s), 78n(d)-(f) (1970)), amended by Act of Dec. 22, 1970, Pub. L. No. 91-567, 84 Stat. 1497; see 17 C.F.R. §§ 240.13d-1 to -4, schedule 13D, 240.14d-1 to -4, schedule 14D (1974). See generally E. ARANOW & H. EINHORN, *TENDER OFFERS FOR CORPORATE CONTROL* 64-146 (1973); H. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* §§ 13.19-30 (1972); 1 A. BROMBERG, *SECURITIES LAW—FRAUD* § 6.3 (1969); 20 R. HAMILTON, *TEXAS BUSINESS ORGANIZATIONS* § 730; R. JENNINGS & H. MARSH, *SECURITIES REGULATION: CASES AND MATERIALS* 936 (3d ed. 1972); 6 L. LOSS, *SECURITIES REGULATION* 3658-69 (Supp. 1969); Bromberg, *Tender Offers: Safeguards and Restraints—An Interest Analysis*, 21 CASE WES. L. REV. 613 (1970); Bromberg, *The Securities Law of Tender Offers*, 15 N.Y.L.F. 462 (1969); Brown, *The Scope of the Williams Act and Its 1970 Amendments*, 26 BUS. LAW. 1637 (1971); Griffin & Tucker, *The Williams Act, Public Law 90-439—Growing Pains? Some Interpretations with Respect to the Williams Act*, 16 HOW. L.J. 654 (1971); Hamilton, *Some Reflec-*

ters,¹¹¹³ that consummation of the tender offer would cause Texasgulf to violate article 1527 of the Texas Revised Civil Statutes¹¹¹⁴ and the consequences that would accrue therefrom. Article 1527 was enacted in 1921¹¹¹⁵ and dealt largely with the powers of a corporation "created for the purpose of engaging in international trading and the purchase and sale of the products of the farm, ranch, orchard, mine and forest"¹¹¹⁶ pursuant to subdivision 79 of former article 1302, the general statute that listed the permissible single purposes for which Texas corporations could then be organized.¹¹¹⁷ However, the statute also provided that a majority of the stock of such corporations had to be owned by citizens of the United States and that a majority of officers and directors must be both United States and Texas citizens. Aliens were permitted to become stockholders "but the control of such corporations shall never in any instance be vested in citizens of other countries than the United States."¹¹¹⁸ If so, a "violation of any provision herein as to the control of stock of such corporation shall be sufficient for the Secretary of State to cancel the charter of said corporation and the same shall be placed in the hands of a receiver as provided by law."¹¹¹⁹ Texasgulf contended that it came within the purview of article 1527 and hence CDC's takeover if successful would violate the statute and would then lead to cancellation of Texasgulf's charter and all of its assets being put into receivership. None of this was divulged in CDC's tender offer as required by the Williams Act, but even if it had been, the statute itself was sufficient grounds for equitable relief. It therefore asked that a preliminary injunction be granted until a hearing on the merits as to the applicability of article 1527 and the consequences of its violation could be held.

Judge Seals of the Southern District of Texas, who conducted a lengthy hearing on Texasgulf's complaint, refused to delay the tender offer on that basis, feeling that all the evidence and arguments concerning article 1527's applicability had been developed at the hearing.¹¹²⁰ In his judgment, article 1527 did not apply to Texasgulf, primarily because it was not an international

tions on Cash Tender Offer Legislation, 15 N.Y.L.F. 269 (1969); Wander, *Selecting Targets and Shaping Strategy in Corporate Take-Overs*, 24 Sw. L.J. 593 (1970).

1113. CDC was also alleged to have failed to disclose (1) the purpose for which it was organized and the conflict of interests it would have as Texasgulf's controlling shareholder with non-Canadian shareholders; (2) its plans and proposal for changes of management and possible spin-off of assets; (3) that it and others had entered into a conspiracy to acquire Texasgulf's stock in violation of sections 13(d) and 14(e) of the Securities Exchange Act, 15 U.S.C. §§ 78m(d), 78n(e) (1972); (4) its acquisition of control would violate section 1 of the Sherman Act, 15 U.S.C. § 1 (1972), and section 7 of the Clayton Act, 15 U.S.C. § 26 (1972); (5) that upon consummation of the tender offer Texasgulf would cease to be eligible for insurance, finance, and other programs administered by the Overseas Private Investment Corporation (OPIC), 22 U.S.C. §§ 2191-2200a (Supp. 1974); (6) consummation of the tender offer would jeopardize radio licenses held by Texasgulf, 47 U.S.C. § 310(a)(5) (Supp. 1974); (7) its control would jeopardize Texasgulf's Australian mining venture. 366 F. Supp. at 386-87.

1114. TEX. REV. CIV. STAT. ANN. art. 1527 (1962).

1115. Ch. 120, §§ 1-3, [1921] Tex. Laws 227 (presently codified as TEX. REV. CIV. STAT. ANN. art. 1527 (1962)).

1116. TEX. REV. CIV. STAT. ANN. art. 1527 (1962).

1117. *Id.* art. 1302, subd. 79, *repealed by* ch. 229, § 1, [1961] Tex. Laws 458.

1118. TEX. REV. CIV. STAT. ANN. art. 1527 (1962).

1119. *Id.*

1120. 366 F. Supp. at 411.

trading corporation within the meaning of the statute. Historically, an international trading company was one, such as the British East India Company and Hudson's Bay Company, that imported raw materials and native products of newly discovered lands into Europe and exported manufactures.¹¹²¹ They were essentially intermediaries, not producers of the materials and products they procured and sold. The Texas statute obviously had such companies in mind in speaking of a corporation that would engage in international trading of the products of "farm, ranch, orchard, mine and forest."¹¹²² The emergency clause of the statute suggested that the legislature was interested in assuring that the then abundant and surplus supply of raw materials in Texas would find an adequate market.¹¹²³ Nothing in the statute indicated it was designed to apply to a corporation such as Texasgulf, a multinational natural resources corporation engaged primarily in mining and extraction and the international sale of its own products. Nor was there anything approximating the language found in article 1527 in Texasgulf's original charter of 1909 when it was formed for the sole purpose of establishing and maintaining an oil business nor in a 1963 amendment thereto adopting a broad purpose clause reflecting its expanded activities.

Prior to the adoption of the TBCA, as Judge Seals correctly noted and Texasgulf conceded, the issue could not have been raised because of the single purpose rule Texas had and Texasgulf's selection of an oil company purpose. But Texasgulf contended that after the TBCA permitted an expansion of corporate purposes, any corporation that adopted a general purpose clause that could possibly be construed to include the trading of natural resources became automatically subject to article 1527. Judge Seals disagreed, saying that article 1527 was designed to deal with a special type of corporation and that unless Texasgulf's purpose clause expressly included international trading, it would be a gross distortion of legislative intent to hold that the statute governs a corporation that is essentially a producer with none of the attributes of the traditional trading corporation. In essence, article 1527 was designed to deal with a specific type of corporation and owed its continuing existence after the TBCA was adopted to the belief by the Bar Committee that it and similar statutes were so limited in their application they need not be tampered with in a general business corporation act.¹¹²⁴ The committee did not conceive that, or as Judge Seals cogently put it, the legislature could

1121. The court relied extensively on an affidavit by Professor Francis Scott Yeager of the University of Houston College of Business giving the historical background of such companies.

1122. TEX. REV. CIV. STAT. ANN. art. 1527 (1962).

1123. The emergency recited was "the fact there is now no adequate law in Texas authorizing the creation of international trading corporations, and the further fact that it is absolutely necessary in the interest of farmers, the ranchmen, and others engaged in the business of producing raw materials in the State of Texas that such corporations be created and brought into existence so that the vast quantity of raw materials now in the hands of producers of the State of Texas find an adequate market." Ch. 120, § 5, [1921] Tex. Laws 228-29.

1124. See TEX. BUS. CORP. ACT ANN. art. 9.15(B) (1956); Comments of Bar Committee to Arts. 9.14-16; 3A TEX. REV. CIV. STAT. ANN. 421-38 (1956); cf. Amsler, *Report of Committee on Revision of Corporate Laws*, 23 TEX. B.J. 327, 328 (1960), discussing a proposed Corporation Code in which article 1527 would be listed as part 12 of a separate chapter recodifying "existing statutes affecting particular corporations."

not have intended that article 1527 was to become "a lurking monster applicable to any corporation which might draw a purpose clause broad enough to include international trading in the products of mines—or the farm, ranch, or forest for that matter."¹¹²⁵

As the author of an affidavit supporting the court's interpretation of the Bar Committee's intentions that became the only item of evidence not considered on the issue because of Texasgulf's objection, to me the court's analysis seems eminently sound.¹¹²⁶ But to be as objective as possible, the parochial philosophy reflected in article 1527 and its harsh penalties are completely alien to that of the TBCA which seeks to liberalize the corporation law of Texas and encourage businesses to incorporate here. Thus, there can be no doubt that had the Bar Committee considered the statute to be the "lurking monster" Judge Seals referred to, it would have sought its repeal or specific exclusion from application to general business corporations. A majority of the committee have always been active practitioners, some of whose corporate clients undoubtedly engaged in some aspect of international commerce. It is hard to believe that such a committee would have taken no action with respect to a statute that would lead to automatic cancellation of any of those clients' charters if a majority of its directors and officers proved not to be citizens of Texas.¹¹²⁷ As Judge Seals aptly stated, "so much of the law is common sense."¹¹²⁸ Certainly his decision with respect to article 1527 in this case exemplifies that observation.

Forfeiture of Charter. One consequence of failing to pay the Texas franchise tax is suspension of the right to do business and ultimately forfeiture of the corporation's charter.¹¹²⁹ But desiring not the death of the taxpayer but rather the collection of his taxes, the Texas law also allows a corporation to revive its existence by paying the back taxes, interest, and penalty.¹¹³⁰ In *Acme Color Art Printing Co. v. Brown*¹¹³¹ the Dallas court of civil appeals had to consider the question of whether a corporation whose charter had been thus forfeited for nonpayment of franchise taxes but later reinstated can maintain an action commenced before its reinstatement. The court held that it could and that it was error to sustain a plea of abatement alleging forfeiture of charter when at the hearing the corporation presented a certificate from the secretary of state showing its charter had been reinstated. The court reasoned that the sole purpose of the franchise tax legislation is to raise

1125. 366 F. Supp. at 415.

1126. *See id.* at 381, 411.

1127. Indeed, CDC contended that Texasgulf should be estopped from claiming the benefits of a statute Texasgulf itself had been violating; allegedly a majority of its directors and officers were not citizens of Texas as required by article 1527. Because of its general ruling that Texasgulf was not subject to article 1527, the court did not pass on the argument except to remark that it would have been one of several serious hurdles that would have had to be cleared if article 1527 did pose a real threat to CDC's threatened takeover. *Id.*

1128. *Id.* at 415.

1129. TEX. TAX-GEN. ANN. art. 12.17 (1969); TEX. BUS. CORP. ACT ANN. arts. 7.01 (B)(1), (C), (D) (Supp. 1974).

1130. TEX. TAX-GEN. ANN. art. 12.17; TEX. BUS. CORP. ACT ANN. art. 7.01(E) (Supp. 1974); *see* Lebowitz, *supra* note 952, at 121.

1131. 488 S.W.2d 507 (Tex. Civ. App.—Dallas 1972), *error ref. n.r.e.*

revenue and that purpose is best served by encouraging the delinquent taxpayer to pay what it owes and thus revive its right to have access to the courts. The decision is the first in Texas on the particular issue,¹¹³² but is consistent with other holdings in Texas¹¹³³ and elsewhere.¹¹³⁴

C. Texas Securities Act

Legislative Changes. Two sections of the Texas Securities Act were amended in 1973. One of the amendments was designed to strengthen the criminal and administrative enforcement of the Act in curbing fraudulent practices and abuses in the sale of municipal bonds and other exempt governmental securities. The other was to make clear that the Act's penal provisions apply to both securities and transactions otherwise exempted from registration under the Act. The changes were drafted by the State Bar Committee on Securities and Investment Banking in close cooperation with the Texas Securities Board and Securities Commissioner, largely in response to their request for assistance in formulating ways of dealing with the municipal bond problem.¹¹³⁵

Securities issued by federal and state governments and their agencies or political subdivisions have traditionally been exempted from registration requirements of federal¹¹³⁶ and state¹¹³⁷ securities laws but generally not from the anti-fraud provisions of such legislation.¹¹³⁸ Although the Texas Secu-

1132. *Id.* at 508.

1133. If the bar to bringing or maintaining a suit is due to forfeiture of the corporation's right to do business rather than its charter for non-payment of the franchise tax, the Texas courts have held that revival of the right by paying back taxes and penalties also revives the right to sue on actions whether accruing before or after forfeiture. See TEX. TAX-GEN. ANN. art. 12.14 (1969); *Federal Crude Oil Co. v. Young-Lee Oil Co.*, 122 Tex. 21, 28, 52 S.W.2d 56, 62 (1932); *Real Estate-Land Title & Trust Co. v. Dildy*, 92 S.W.2d 318, 322 (Tex. Civ. App.—Austin 1936), *error ref.*; *cf. McGown v. Kittle*, 480 S.W.2d 47 (Tex. Civ. App.—Fort Worth 1972), *error ref. n.r.e.*, discussed in Lebowitz, *supra* note 952, at 122.

1134. See, e.g., *Matanzas Packing Co. v. Rayonier, Inc.*, 195 F.2d 523, 524 (5th Cir. 1952); *Rooney v. Vermont Inv. Co.*, 10 Cal. 3d 351, 515 P.2d 297, 302, 110 Cal. Rptr. 353, 357 (1973); *Town of Davie v. Hartline*, 199 So. 2d 280, 282 (Fla. 1967); *J.B. Wolfe, Inc. v. Salkind*, 3 N.J. 312, 70 A.2d 72, 76 (1949). See generally 16A W. FLETCHER, CYCLOPEDIA CORPORATIONS § 7998; Annot., 13 A.L.R.2d 1220 (1950) (reinstatement of repealed, forfeited, expired, or suspended corporate charters as validating acts in interim).

1135. Haynes, *Texas Securities Act*, 35 TEX. B.J. 1135 (1972).

1136. E.g., Securities Act of 1933, § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1972). See generally H. BLOOMENTHAL, *supra* note 1112, §§ 1.02[4], 2.24[2]; 1 L. LOSS, *supra* note 1112, at 560-66; H. SOWARDS, FEDERAL SECURITIES ACT § 3.03 (1974).

1137. E.g., ALA. CODE tit. 53, § 4 (1960); MD. ANN. CODE art. 32A, § 26 (1971); MASS. GEN. LAWS ANN. ch. 110A, § 4(b) (1967); MINN. STAT. § 80.05(2) (1968); N.J. REV. STAT. § 49:3-50(a)(1) (1970); S.C. CODE ANN. § 62-51(1) (1962); TEX. REV. CIV. STAT. ANN. art. 581-6(A) (1964); WIS. STAT. § 551.22 (Supp. 1974); see UNIFORM SECURITIES ACT § 402(a)(1). See generally H. BLOOMENTHAL, *supra* note 1112, § 14.02; 1 L. LOSS, *supra* note 1112, at 65-66; L. LOSS & E. COWETT, BLUE SKY LAW, Appendix I, at 352-53 (1958); J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 60 (1971).

1138. E.g., SEC v. Charles A. Morris & Associates, Inc., [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,756, at 93,300 (W.D. Tenn. 1973), *permanent injunction granted*, SEC. REG. & L. REP. No. 242, at A-17 (W.D. Tenn. Feb. 6, 1974); *Thiele v. Shields*, 131 F. Supp. 416, 419 (S.D.N.Y. 1955); *Greenwich Sav. Bank v. Shields*, 131 F. Supp. 368, 369 (S.D.N.Y. 1955); *Baron v. Shields*, 131 F. Supp. 370, 372 (S.D.N.Y. 1954); *H. Montgomery Snyder, Inc.*, [1970-71 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,996, at 80,189 (S.E.C. 1971); *Walston & Co., Inc. and Harrington*, 43 S.E.C. 508,

urities Act recognizes a civil remedy for the fraudulent sale of an exempt security,¹¹³⁹ until 1973 there had been considerable doubt whether the penal sanctions set out in section 29 would apply.¹¹⁴⁰ This was because sections 5 and 6, the provisions listing exempt transactions and exempt securities, respectively, each began by saying that "except as hereinafter in this Act specifically provided"¹¹⁴¹ the Act did not apply to such transactions or securities. Since section 29 made no specific mention of either section, in contrast to section 33(A)(2) providing a civil remedy for fraudulent offers or sales "whether or not the security or transaction is exempt under Section 5 or 6 of this Act,"¹¹⁴² the view of the Securities Board that the exemptions afforded were only from registration requirements and not from prosecution¹¹⁴³ was certainly arguable at least. Moreover, even though section 23 of the Act specifically gave the Commissioner the right to issue cease and desist orders to prevent the sale or proposed sale of securities that would work a fraud on purchasers or would not be fair, just, or equitable irrespective of exemptions, the sale of domestic governmental securities was expressly excluded from such orders.¹¹⁴⁴ The exclusion was probably inserted as a matter of comity and practicality but raised no real enforcement problems until recent years. Due to a proliferation of bonds and other obligations issued by local or special governmental units these securities began to be sold or traded under extremely questionable circumstances and through high-pressure and deceptive sales tactics by a small group of dealers operating outside the realm of established and traditional municipal bond specialist firms.¹¹⁴⁵

The problem became the concern of the Texas Securities Board when a number of small Texas banks fell victim to the improper trading practices

[1966-67 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,474 (1967). *But cf.* Securities Act of 1933, § 12(2), 15 U.S.C. § 77l(2) (1972) (exempting sale of governmental securities from civil liability). *See generally* H. BLOOMENTHAL, *supra* note 1112, §§ 2.24[2], 8.05; 1 A. BROMBERG, *supra* note 1112, § 2.4(3); L. LOSS & E. COWETT, *supra* note 1137, at 390; H. SOWARDS, *supra* note 1136, § 3.01[1]; Robinson, *The Application of Federal Securities Laws to Municipal Financing*, in PLI, MUNICIPAL BOND PROBLEMS ADVANCED WORKSHOP 9, 20 (1969).

1139. TEX. REV. CIV. STAT. ANN. art. 581-33(A)(2) (1964).

1140. Haynes, *supra* note 1135, at 1135; *cf.* Bordwine, *Criminal Liability Under the Texas Securities Act*, 35 TEX. B.J. 107, 112 (1972).

1141. TEX. REV. CIV. STAT. ANN. arts. 581-5, -6 (1964).

1142. *Id.* art. 581-33(A)(2).

1143. Haynes, *supra* note 1135, at 1135.

1144. Ch. 269, § 23, [1957] Tex. Laws 575.

1145. *See, e.g.*, SEC v. The Senex Corp., CCH FED. SEC. L. REP. ¶ 94,735, at 96,441 (E.D. Ky., July 24, 1974) (complaint); SEC v. First United States Corp., SEC. REG. & L. REP. No. 217, at A-10 (W.D. Tenn. Aug. 22, 1973) (complaint); SEC v. Investors Associates of America, [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,644 (W.D. Tenn. 1972) (complaint); SEC v. Charles A. Morris & Associates, [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,643 (W.D. Tenn. 1972) (complaint); *Comptroller Warns of "Unethical" Municipal Bond Selling Practices*, SEC. REG. & L. REP. No. 115, at A-9 (Aug. 18, 1971); *Comptroller of the Currency, Banking Circular No. 2, Supp. No. 2* (Aug. 8, 1971), summarized in CCH FED. BANKING L. REP. ¶ 49,202.15; *Antifraud Violation Alleged Against Municipal Bond Dealers*, SEC. REG. & L. REP. No. 175, at A-8 (Oct. 26, 1972); *Special Report: Bill Subjecting Dealers and Banks Selling Municipals to SEC Regulation Is Passed By Senate*, SEC REG. & TRANSFER REP., Oct. 31, 1974, at 1, 3; *Fraud Is Charged Against Paragon Securities Co.*, Wall Street Journal, Aug. 8, 1973, at 8, col. 1 (Southwestern ed.); *Municipal Bond Dealers Discuss Establishment of Self-Regulatory Plan*, Wall Street Journal, Dec. 4, 1972, at 12, col. 4 (Southwestern ed.); *Feasibility of Municipal Bond Regulation Will Be Studied by an NASD Committee*, Wall Street Journal, May 18, 1972, at 3, cols. 2, 3 (Southwestern ed.).

of some of these new bond firms and their salesmen, nearly all operating from outside the state. Such practices consisted, for example, of encouraging overtrading,¹¹⁴⁶ misquoting bond ratings, coupon price, maturity, and yield; offering bonds at current yield price instead of true tax exempt yield; selling revenue bonds as general obligation unlimited tax bonds; breaking confirmed trades because of market conditions or inability to procure delivery; and so-called "tailgating." In "tailgating," several firms work in conjunction with each other by having the first firm offer the bonds at an extremely high price, then others offer them at a reduced price, misleading the banker into thinking he is getting a bargain when in reality the sales price is still well above market. Of course, such sales were not confined to Texas banks or financial institutions and ultimately led to action by the SEC and other state blue sky law agencies.¹¹⁴⁷ But in Texas, faced with the Texas Securities Act language that effectively hamstrung enforcement, there was little that could be done.

New legislation was the obvious solution. First, section 23 was amended to delete the exclusionary language so that now cease and desist orders can be issued with respect to fraudulent or unfair sales of governmental as well as other exempt or non-exempt securities or transactions.¹¹⁴⁸ Secondly, the two most relevant subsections of section 29 were amended to make them applicable "whether or not the transaction or security is exempt under Sections 5 or 6 of this Act."¹¹⁴⁹ These were subsection C penalizing fraud or fraudulent practices in the sale of securities in Texas¹¹⁵⁰ and subsection E providing criminal sanctions for knowingly making or causing to be made any material false or misleading statement in any document filed with the Commissioner or in any proceeding under the Act.¹¹⁵¹ In the process, the "fraud or fraudulent practice" language in subsection C was supplemented by adding rule 10b-5's formulation of securities law fraud,¹¹⁵² thus permitting utilization of that rule's tremendous body of judicial interpretation.¹¹⁵³ The whole section was re-enacted so that former subsection H could become subsection G and fill the gap left by former subsection G's repeal in 1963.¹¹⁵⁴

1146. Overtrading usually occurs in the following manner. A bank which owns bonds carried on its books at cost but having a current market value below cost sells such bonds at a price above market (normally at the price equivalent to book value). The bank then purchases other bonds from the same broker (often having a longer maturity and higher yield) at a price above market in order to compensate the broker for the loss on the bonds sold him by the bank and for his broker's fee. The bonds are then recorded at the new cost above market and as a result recognition of the loss on the bonds sold by the bank is deferred. The new bonds are placed on the bank's books at a price above their true market value when purchased. Generally the bank's books will not properly disclose all of these circumstances. See Comptroller of the Currency, Banking Circular No. 2, *supra* note 1145.

1147. See authorities cited in notes 1138, 1145 *supra*.

1148. Ch. 97, § 1, [1973] Tex. Laws 216, amending TEX. REV. CIV. STAT. ANN. art. 581-23(A) (Supp. 1974).

1149. Ch. 97, § 2, [1973] Tex. Laws 217, amending TEX. REV. CIV. STAT. ANN. arts. 581-29(C), (E) (Supp. 1974).

1150. TEX. REV. CIV. STAT. ANN. art. 581-29(C) (Supp. 1974).

1151. *Id.* art. 581-29(E).

1152. 17 C.F.R. § 240.10b-5 (1974). See generally A. BROMBERG, *supra* note 1112; W. PAINTER, *FEDERAL REGULATION OF INSIDER TRADING* (1968).

1153. Haynes, *supra* note 1135, at 1136.

1154. Former subsection G penalized the knowing declaration, issuance or payment of cash dividends out of any fund other than the actual earnings of the issuer or from the lawful liquidation of its business. It was repealed at the initiative of the Committee

Case Construction. Now and then some of the Texas courts of civil appeals manage to come up with patent misconstructions of the Texas Securities Act¹¹⁵⁵ as one of three recent cases construing the Act demonstrates. Section 34 of the Act became the latest victim of judicial misreading in *Rowland Corp. v. Integrated Systems Technology, Inc.*,¹¹⁵⁶ a decision by the Waco court of civil appeals that has been justly criticized not only for ignoring precedent but also for being "wrong in terms of grammar, structure, history and policy."¹¹⁵⁷

Rowland Corporation brought an action to recover a commission promised it in a letter agreement by Integrated Systems Technology (IST). IST agreed to pay Rowland ten percent of all sums invested by certain named individuals in a private placement of a note offering which IST was making. Although two of the named individuals invested a total of \$85,000, IST refused to pay Rowland its commission. The trial court granted a summary judgment against Rowland, which was not licensed as a Texas securities dealer, on the ground that section 34 of the Act bars recovery of a commission by an unlicensed dealer or salesman.¹¹⁵⁸ Rowland contended that since the private placement was an exempt transaction under section 5(I)¹¹⁵⁹ the section 34 bar did not apply.

The Waco court of civil appeals affirmed. In its brief one-page opinion without citation of authority other than the Securities Act, the court began by quoting the section 34 provision that a person or company cannot bring an action to collect a commission or compensation for services rendered in the sale or purchase¹¹⁶⁰ of securities without proof of licensing as a dealer

on Securities and Investment Banking in the belief the provision had no place in a securities law, especially since nothing in it referred to other parts of the Act, and because the subject matter was more effectively covered by TBCA articles 2.38 and 2.41, ch. 170, § 11, [1963] Tex. Laws 473; see Comment—1963 Amendment to Art. 581-29(G), 1B TEX. REV. CIV. STAT. ANN. 61 (1964).

1155. See, e.g., *Dempsey-Tegeler & Co. v. Flowers*, 465 S.W.2d 208 (Tex. Civ. App.—Beaumont), *rev'd*, 472 S.W.2d 112 (Tex. 1971), discussed in Lebowitz, *supra* note 1085, at 112-15; *Tumblewood Bowling Corp. v. Matise*, 388 S.W.2d 479 (Tex. Civ. App.—Beaumont 1965), *error ref. n.r.e.*, discussed in Bromberg, *Texas Exemptions for Small Offerings of Corporate Securities—The Prohibition on Advertisements*, 20 Sw. L.J. 239 (1966), and in 4 BULL. OF THE SECTION ON CORP., BANKING & BUS. L., Oct. 1965, at 1.

1156. 488 S.W.2d 133 (Tex. Civ. App.—Waco 1972), *error ref. n.r.e.*

1157. Bromberg, *Collectibility of Commissions on Exempt Transactions in Securities*, BULL. OF THE SECTION ON CORP., BANKING & BUS. L., Oct. 1973, at 3.

1158. TEX. REV. CIV. STAT. ANN. art. 581-34 (1964).

1159. *Id.* art. 581-5(I). The sale may have been exempt either because IST still would not have had 35 security holders after taking the sale into account, or because it had not sold securities not otherwise registered or exempt or sold in exempt transactions to more than 15 persons within the preceding twelve months. See generally 20 R. HAMILTON, TEXAS BUSINESS ORGANIZATIONS § 758, at 297-302; Bromberg, *Texas Exemptions for Small Offerings of Corporate Securities*, 18 Sw. L.J. 537 (1964); Bromberg, *supra* note 1155; Lebowitz, *supra* note 1085, at 131-39; Meer, *A New Look at the Texas Securities Act*, 43 TEXAS L. REV. 680 (1965).

1160. This provision is unlike the other provisions of the Texas Securities Act, which are specifically limited to offers or sales of securities and the protection of purchasers and not to purchases or protection of sellers. See, e.g., *Ham v. Blankenship*, 194 F.2d 430, 431 (5th Cir. 1952); *Brown v. Cole*, 155 Tex. 624, 628-29, 291 S.W.2d 704, 708 (1956); *Lewis v. Davis*, 145 Tex. 468, 474, 199 S.W.2d 146, 149 (1947); *Fowler v. Hults*, 138 Tex. 636, 642, 161 S.W.2d 478, 481 (1942); *Dunnam v. Dillingham*, 345 S.W.2d 314, 318 (Tex. Civ. App.—Austin 1961). Section 34 applies to actions to recover commissions for both purchases and sales of securities. *Maddox v. Flato*, 423

or salesman and proof that the securities sold were registered at the time of the sale. The section then adds: "[P]rovided, however, that this section or provision of this Act shall not apply to the exempt transactions set forth in Section 5 of this Act nor to the sale and purchase of exempt securities listed in Section 6 of this Act, *when sold by a registered dealer*."¹¹⁶¹ In the court's view, the italicized phrase applied to both the section 5 and section 6 exemptions, although incongruously it then stated: "The non-application of requirement that plaintiff maintaining action for commission have license, is thus dependent on the *sale of exempt securities* being made by a registered dealer."¹¹⁶² This of course is what the statute says: a commission for the sale of an exempt security cannot be recovered unless the sale is made by a registered dealer. But here the issue concerned an exempt transaction, not the sale of an exempt security. Nevertheless, the court concluded that because the sale had not been made by a registered dealer, the plaintiff could not recover its commission.

Professor Bromberg has written an excellent critique of the *Rowland* opinion¹¹⁶³ and much of the analysis given here reflects his views. To begin with, the effect of the court's grammatical construction of the proviso is to make it read that the section 34 bar will not apply "to the exempt transactions set forth in Section 5 . . . when sold by a registered dealer." Since dealers obviously do not sell transactions, it is quite apparent the phrase "when sold by a registered dealer" was intended only to modify the sales and purchases of exempt securities by such dealers.¹¹⁶⁴

This interpretation is supported by section 6 of the Act which lists the various securities which are exempted from registration "when offered for sale, or sold, or dealt in by a registered dealer or salesman of a registered dealer."¹¹⁶⁵ In contrast, section 5 which deals with exempt transactions, states that unless otherwise provided, a sale of securities does not come under the Act when made in one of the transactions and under the conditions specified "and the company or person engaged therein shall not be deemed a dealer within the meaning of this Act."¹¹⁶⁶ However, the Act does require that certain exempt transactions, mainly those affecting the investing public, be conducted through a registered dealer. These include, for example, secondary trading in outstanding securities¹¹⁶⁷ or private offering of oil and gas securities when limited to no more than thirty-five sales within a twelve-month period.¹¹⁶⁸ On the other hand, the Act's silence as to the need for

S.W.2d 371, 374 (Tex. Civ. App.—Corpus Christi 1967), *error ref. n.r.e., discussed in* Amsler, *supra* note 1090, at 104; Shriver v. Stoddard, 188 S.W.2d 892, 894 (Tex. Civ. App.—Dallas 1945), *error ref.*

1161. TEX. REV. CIV. STAT. ANN. art. 581-34 (1964) (emphasis added). The legislative history and derivation of section 34 are traced in Maddox v. Flato, 423 S.W.2d 371, 374 (Tex. Civ. App.—Corpus Christi 1967).

1162. 488 S.W.2d at 134 (emphasis added).

1163. See Bromberg, *supra* note 1157.

1164. *Id.* at 3.

1165. TEX. REV. CIV. STAT. ANN. art. 581-6 (1964).

1166. *Id.* art. 581-5.

1167. *Id.* art. 581-5(O). See generally Meer, *supra* note 1159, at 698.

1168. *Id.* art. 581-5(Q). See generally Fleming & Joor, *Oil and Gas Interests as Securities Under the Federal and Texas Securities Acts*, 5 BULL. OF THE SECTION ON CORP., BANKING & BUS. L., Nov. 1966, at 1, 3.

utilizing a registered dealer in the other exempt transactions listed, including section 5(I), the general private offering exemption relied on by plaintiff, strongly supports the inference that these sales may be conducted by an unlicensed dealer. This rather broad exclusion of exempt transactions, but not exempt securities, from the dealer registration requirement reflects a legislative policy that those who deal in securities whether exempt or not which may be sold to the public or engage in public transactions should be licensed. On the other hand, those who participate in transactions that are essentially private in nature and which do not constitute the conduct of a securities business need not be licensed. Thus, since the legislature "decided not to require licenses for most exempt transactions, it could hardly have intended by § 34 to impose gratuitous service on all those who participate in them."¹¹⁶⁹ The Waco court's conclusion that this in effect is what section 34 does impose simply cannot be justified. It flies in the face of not only the general understanding among the securities bar concerning the meaning of section 34¹¹⁷⁰ (admittedly not authoritative), but more importantly the body of precedent that directly or inferentially supports the accepted interpretation.¹¹⁷¹

If the *Rowland* opinion could be passed off as an aberrant construction not likely to be followed, there would be no cause for concern. But given the infrequency with which the Securities Act is interpreted, any case construction of its provisions becomes important when it unsettles the policies and philosophy of regulation the Act is designed to effectuate and causes uncertainty as to the validity of certain securities transactions. Moreover, as Professor Bromberg points out,¹¹⁷² the decision can have a number of unexpected results. Because section 34 somewhat expansively refers to compensation as well as commissions for services rendered in the sale or purchase of securities, its terms might well encompass a lawyer or accountant who must sue for his work in connection with a private placement. Non-Texas dealers not licensed here who arrange for sales to institutional investors in Texas as exempted in section 5(H)¹¹⁷³ could not recover their commissions in Texas courts. Even executors or administrators arranging for the sale of securities, as permitted in section 5(A),¹¹⁷⁴ may face legal objections to the collection of fees for their services in connection with the sale. Similarly, compensation paid employees of an issuer of exempt securities for their work in selling its securities might be questioned even though the sale is exempted by section 5(R).¹¹⁷⁵

1169. Bromberg, *supra* note 1157, at 3.

1170. *Id.*

1171. *E.g.*, Gerchshheimer v. American Heritage Bank & Trust Co., 437 F.2d 1332, 1335 (10th Cir. 1971), discussed in Lebowitz, *supra* note 1085, at 126 (recovery of commission by unlicensed dealer in section 5(H) transaction); see Winslow v. Boyd, 195 S.W.2d 384, 386 (Tex. Civ. App.—Galveston 1946) (recovery of compensation under section 5(C) and predecessor of section 5(I)); cf. Development Inv. Corp. v. Diversa, Inc., 393 S.W.2d 653, 656-58 (Tex. Civ. App.—Texarkana 1965); Tumblewood Bowling Corp. v. Matise, 388 S.W.2d 479 (Tex. Civ. App.—Beaumont 1965), *error ref. n.r.e.*; Flournoy v. Gallagher, 189 S.W.2d 108, 110-11 (Tex. Civ. App.—Eastland 1945); see Bromberg, *supra* note 1157, at 3.

1172. Bromberg, *supra* note 1157, at 4.

1173. TEX. REV. CIV. STAT. ANN. art. 581-5(H) (1964).

1174. *Id.* art. 581-5(A).

1175. *Id.* art. 581-5(R).

It is apparent the cure for the actual and potential harm created by *Rowland* must come from the legislature. It should come as no surprise, therefore, to learn that the State Bar Committee on Securities and Investment Banking has proposed an amendment to section 34 that will correct the Waco court's erroneous construction¹¹⁷⁶ and make clear once and for all that registration as a dealer is not required as a prerequisite to a recovery of commissions in an exempt transaction. The proposal, however, would go one step further and also make the section 34 bar inapplicable to an action for commissions or compensation in the sale of any security exempted by section 6. But this would effect no real change in the law because, as noted earlier,¹¹⁷⁷ the exemption afforded the securities listed in section 6 is conditioned upon their being offered for sale or being sold or being dealt in by a registered dealer or its salesman. Nevertheless it was thought best to eliminate the concluding "when sold by a registered dealer" phrase from section 34 altogether, no doubt to be doubly sure some other court of civil appeals will not come up with the same result as *Rowland*.

The second of the securities law cases suggests another possible way in which the Waco court might have erred in its decision. The facts in *Rowland* are so succinctly stated that it is difficult to tell, but it is conceivable that Rowland may have done no more than locate and determine the interest of the private placees named in the agreement who then directly negotiated the terms of the private placement with IST. If so, Rowland's role may not have been at all that of a broker or dealer required to be registered under the Texas Securities Act, but rather that of a finder, who, as held in *Rogers v. Ellsworth*,¹¹⁷⁸ need not be licensed at all.

In the *Rogers* case, the defendant, a majority shareholder of an exploration company, indicated to plaintiff, a broker or finder of business opportunities in the geophysical exploration industry, that he wanted to sell out, preferably to a corporation that would operate his company as a subsidiary or merge with it. The two agreed that plaintiff would try to interest various prospects, and ultimately all of the defendant's shares were sold to one such prospect, an electronics corporation. Even so, the defendant refused to pay the plaintiff the agreed finder's fee of three percent of the gross sales price and plaintiff brought suit. The defendant responded that because plaintiff was not a licensed securities dealer, he was barred from recovering his commission under section 34.¹¹⁷⁹ The plaintiff, however, claimed he had not sold secu-

1176. Memorandum Re Proposed Amendments to the Texas Securities Act Recommended by the Council of the Section on Corporation, Banking and Business Law and Its Securities Committee to the Board of Directors of the State Bar of Texas for Inclusion in the Legislative Package to be Sponsored by the State Bar at the 1975 Regular Session of the Texas Legislature, at 6, enclosed in letter dated June 17, 1974, from Fletcher L. Yarbrough, Chairman of Committee on Securities and Investment Banking to Richard D. Haynes, Chairman, Section of Corporation, Banking and Business Law.

As proposed, the proviso at the end of section 34 would read: "provided, however, that this section or provision of this Act shall not apply (1) to any transaction exempted by Section 5 of this Act, nor (2) to the sale or purchase of any security exempted by Section 6 of this Act."

1177. See text accompanying note 1165 *supra*.

1178. 501 S.W.2d 756 (Tex. Civ. App.—Houston [14th Dist.] 1973), *error ref. n.r.e.*

1179. TEX. REV. CIV. STAT. ANN. art. 581-34 (1964).

rities but simply acted as the finder of a business opportunity. Although no issue was submitted as to whether the contract contemplated the sale of securities, the jury found that plaintiff had set in motion the events that led to the sale and that a contract to pay a commission existed. The trial court then awarded plaintiff a judgment on the verdict.

The Houston (14th District) court of civil appeals affirmed. It granted that a basic element of the plaintiff's case had not been submitted, *i.e.*, whether the contract contemplated or involved the sale of securities. Even so, no objection was raised and the issue would therefore be regarded as a deemed issue under the Texas Rules of Civil Procedure¹¹⁸⁰ as long as there was proper ground of recovery. While no Texas cases had previously distinguished between a broker and a finder, the distinction had been impliedly recognized.¹¹⁸¹ A finder, the court said, "is an intermediary who contracts to find and bring parties together, but he leaves the ultimate transaction to the principals; he is the procuring cause, and his function ceases when negotiations between the principals begin."¹¹⁸² Since the verdict inferred no sale of securities had been involved, the rule would apply that a finder is not precluded from recovering compensation for having located a buyer or seller even if he is not licensed as a real estate or securities dealer.¹¹⁸³

The holding in *Rogers* is somewhat less than satisfying in view of the faulty issue submission as to the nature of the transaction. In a somewhat similar case¹¹⁸⁴ plaintiff sued for a commission he alleged he had been promised to locate a buyer for some stock in a Texas corporation. A buyer was finally obtained through the efforts of a stock brokerage firm that plaintiff had asked to assist him, but the plaintiff never knew the identity of the buyer. The

1180. TEX. R. CIV. P. 279. *See generally* G. HODGES, SPECIAL ISSUE SUBMISSION IN TEXAS 190-222 (1959); 3 R. McDONALD, TEXAS CIVIL PRACTICE § 12.36.4 (1970); Doo-ley, *Special Issues Under the New State and Federal Rules*, 20 TEXAS L. REV. 32, 38 (1941); 29 TEXAS L. REV. 537 (1951); 23 TEXAS L. REV. 189 (1945).

1181. *Cf. Hall v. Hard*, 160 Tex. 565, 335 S.W.2d 584 (1960), an action to recover a commission for procuring a buyer for motor freight properties. Issues were raised that should have been submitted as to whether the transaction involved the sale of realty and securities so as to bar plaintiff's recovery in that he was not licensed as either a real estate broker or securities dealer. It was held that since the issues were not submitted nor had the trial court made any findings of fact, the case would have to be remanded. On remand, the trial court found the contract did not contemplate or include the sale of securities, thus inferring plaintiff must have rendered his services in another capacity, *i.e.*, as a finder. *D.C. Hall Transp., Inc. v. Hard*, 355 S.W.2d 257, 258 (Tex. Civ. App.—Fort Worth), *error ref. n.r.e.*, 358 S.W.2d 117 (Tex. 1962) (*per curiam*).

1182. 501 S.W.2d at 757. *See also* *Tyrone v. Kelley*, 9 Cal. 3d 1, 9, 507 P.2d 65, 70, 106 Cal. Rptr. 761, 766 (1973); *Modern Tackle Co. v. Bradley Indus.*, 11 Ill. App. 3d 582, 297 N.E.2d 688, 692 (1973); Annot., 24 A.L.R.3d 1160, 1164 (1969) (validity, construction, and enforcement of business opportunities or "finder's fee" contract).

1183. *E.g.*, *C.B. Snyder Realty Co. v. Sherrill-Noonan, Inc.*, 261 F.2d 269, 274 (3d Cir. 1958) (applying Pennsylvania law); *Tyrone v. Kelley*, 9 Cal. 3d 1, 8, 507 P.2d 65, 69, 106 Cal. Rptr. 761, 765 (1973); *Seckendorf v. Halsey, Stuart & Co.*, 229 App. Div. 318, 241 N.Y.S. 300 (1930); *see* Annot., *supra* note 1182, at 1173; *cf. South Umpqua Mining Co.*, 3 S.E.C. 233, 241 (1938) (finder not an underwriter); 3 L. Loss, *supra* note 1112, at 1299, 4 *id.* at 2581; *WHEN CORPORATIONS GO PUBLIC* 36-40 (C. Israels & G. Duff eds. 1962). *Contra, e.g.*, *Corson v. Keane*, 4 N.J. 221, 72 A.2d 314, 317 (1950); *Alford v. Raschiatore*, 163 Pa. Super. 635, 63 A.2d 366, 369 (1949); *Chapman Co. v. Service Broadcasting Corp.*, 52 Wis. 2d 32, 187 N.W.2d 794, 800 (1971); *see* Annot., *supra* note 1182, at 1172.

1184. *Gerchsheimer v. American Heritage Bank & Trust Co.*, 437 F.2d 1332 (10th Cir. 1971) (applying Texas law), *discussed in* *Lebowitz*, *supra* note 1085, at 126.

court in permitting plaintiff to recover seemed to assume he had been acting as a securities dealer or broker who was excused from alleging or proving he had been licensed only because the transaction was exempt under section 5(H).¹¹⁸⁵ Moreover, the definition of a dealer in the Texas Securities Act to include one who invites offers for securities or who deals with them in any other manner may be sufficiently broad to cover the activities of a business opportunity broker or finder since not infrequently such opportunities manifest themselves, as in *Rogers*, in the form of an acquisition consummated for shares or other securities rather than through a purchase of assets. There would appear to be as much need for licensing such brokers or finders who actively engage in their vocation on a full- or part-time basis as there is for registration of real estate brokers¹¹⁸⁶ or securities dealers. Whether their regulation should be subsumed under either licensing law or provided for separately deserves legislative consideration.¹¹⁸⁷

The third securities law case, *Bierschwale v. Oakes*,¹¹⁸⁸ involved section 33, the civil liabilities provision of the Texas Securities Act. In a novel interpretation, the court of civil appeals construed that section so as to encompass a constructive trust among the remedies afforded. The facts of the case are somewhat involved, as is the court's opinion; consequently only those aspects needed to explain the securities law issues are given here.

The principal actor in the law suit was the defendant Oakes. He had gotten control of a wholesale hardware firm through the medium of Southern Investors, a shell corporation, by pursuing a plan of financing that resulted in the assets of the hardware company being used to pay for the controlling shares held by Southern.¹¹⁸⁹ A few months later Oakes sold his shares in Southern to three associates in the hardware firm in return for a series of

1185. TEX. REV. CIV. STAT. ANN. art. 581-5(H) (1964) (exempting sales to institutional investors or registered dealers).

1186. TEX. REV. CIV. STAT. ANN. art. 6573a, § 19 (1969).

1187. Cf. N.Y. GEN. OBLIG. LAW § 5-701, subd. 10 (McKinney 1964), the New York statute of frauds, that requires a contract to pay compensation for negotiating the sale of a business opportunity or business or an interest therein "including a majority of the voting stock interest in a corporation" to be in writing. Because of ambiguity in its terms, the statute was amended in 1964 to specifically include finders by defining negotiating to include the procuring of an introduction to a party to the transaction or assisting in the negotiation or consummation of the transaction. Ch. 561, [1964] N.Y. Laws; see *Minichiello v. Royal Business Funds Corp.*, 18 N.Y.2d 521, 223 N.E.2d 793, 277 N.Y.S.2d 268 (1966), *cert. denied*, 389 U.S. 820 (1967).

1188. 497 S.W.2d 506 (Tex. Civ. App.—Houston [1st Dist.] 1973), *rev'd sub nom. Meadows v. Bierschwale*, 516 S.W.2d 125 (Tex. 1974). The Texas Supreme Court, in reversing, specifically declined to reach the issues under the Texas Securities Act. 516 S.W.2d at 130. See note 1193 *infra*.

1189. Oakes had Southern Investors take over a control block of stock in the hardware company which he had previously acquired and assume a bank loan he had obtained to finance the acquisition. He then had the hardware company borrow \$850,000, secured by a pledge of its inventory, accounts receivable, and fixed assets, from which its debts were paid. The hardware company then sold a warehouse and inventory in Galveston for \$297,000, the proceeds of which were used to redeem most of its outstanding common stock for \$278,518.31. Finally, the hardware company loaned Southern Investors \$50,000 with which it purchased the remaining control stock. *Id.* at 512. For somewhat similar bootstrap financing arrangements, see, e.g., *Manney & Co. v. Texas Reserve Life Ins. Co.*, 407 S.W.2d 345 (Tex. Civ. App.—Dallas 1966), discussed in *Lebowitz, Recent Texas Decisions in Corporation, Banking and Business Law*, 5 BULL. OF THE SECTION ON CORP., BANKING & BUS. L., June 1967, at 1, 2; *Milam v. Cooper Co.*, 258 S.W.2d 953 (Tex. Civ. App.—Waco 1953), *error ref. n.r.e.*

ninety-three promissory notes each in the amount of \$2,000, payable \$30 per month. Shortly thereafter Oakes approached Meadows, a real estate broker, and told him he was interested in trading some of the notes for income producing property. Meadows showed him an apartment complex owned by Bierschwale and the other plaintiffs which Oakes ultimately purchased in exchange for forty-seven of the notes with another twelve being given to Meadows as his commission on the sale. During the course of the negotiations Oakes represented to the plaintiffs that the hardware company, whose shares along with Southern's secured the notes, was a good, money-making, well-managed business, and provided them with a condensed financial statement which Oakes claimed had been taken from the most recent audited statement that showed assets in excess of two million dollars and a surplus of \$442,449. He did not tell them the hardware company had lost almost a million dollars in the past five years and that he had withdrawn large sums of money from the company while he managed it. After the deal was closed, only two payments were made on the notes and the hardware company ultimately went into bankruptcy. In the meantime, Oakes conveyed the apartment property to a wholly owned corporation, United Properties, Inc., which in turn sold the apartments to one Goldman for \$40,000 in cash and twenty-four notes totalling almost \$94,000 for the balance.

Bierschwale and the other plaintiffs sued Oakes and United to impose a constructive trust on the cash and notes received from the sale to Goldman, based on their equitable right to rescission and the statutory rescission remedy provided by section 33. There were a number of jury findings, the most important of which found that Oakes had transferred the notes to the plaintiffs by means of untrue statements of material facts but that while plaintiffs did not know such statements were untrue they could have known they were in the exercise of reasonable care. The trial court nevertheless rescinded the exchange agreement for fraud in the procurement, and imposed a constructive trust on the proceeds of the sale of the property by United to Goldman, including cash received and the Goldman notes.

The Houston (First District) court of civil appeals affirmed, although modifying the judgment with respect to Meadows, who had intervened, and the lien holders on the property.¹¹⁹⁰ Despite the jury finding that plaintiffs through due diligence could have learned that Oakes' statements were untrue, there was ample basis on general equitable grounds for rescission for fraud

1190. The trial court had awarded Meadows and his wholly owned corporation a constructive trust on the portion of the proceeds represented by the notes they had received by way of commission and had made certain of the notes given to the plaintiffs subject to liens of others to whom notes had been pledged by Oakes. The court of civil appeals ruled that Meadows and his company were not entitled to have the trust imposed because they had not owned or had any interest in the apartments used as consideration for their acquisition nor had they purchased the notes from Oakes. Instead the notes had been purchased by the plaintiffs (who were awarded title to all the notes) and had been transferred to Meadows as a matter of convenience. 497 S.W.2d at 521. The supreme court later reversed on this point and held that Meadows should share in the constructive trust res, as adjudged by the trial court. 516 S.W.2d at 132. As to the pledgees, the plaintiffs were ruled to have a superior equity as lien creditors as to proceeds paid on the notes by Goldman because the pledgees had not perfected their security interest under the Texas Uniform Commercial Code, TEX. BUS. & COMM. CODE ANN. §§ 9.203, 9.301(c) (Supp. 1974). 497 S.W.2d at 525-26.

because there was no showing the plaintiffs knew of the untruth or had knowledge of any facts that would cause a reasonable, prudent person to make inquiry since in general there is no duty on the part of a defrauded party to investigate the truth or falsity of statements made to him unless he knows facts that should reasonably lead to an inquiry.¹¹⁹¹ Oakes conceded that if there had been fraud, a constructive trust on the Goldman notes would have been proper, but argued that by imposing a trust on the balance of the proceeds plaintiffs were being awarded more than the damage they actually suffered. The court in response applied the basic principles enunciated in the *Restatement of Restitution* that one who becomes a constructive trustee of property he has acquired by fraud has a duty to reconvey the property and if he wrongfully disposes of the property and profits therefrom he can be compelled to surrender the profit as well to prevent unjust enrichment.¹¹⁹²

The court next considered whether recovery could be had under the Texas Securities Act.¹¹⁹³ There was no question the notes were securities under the Act;¹¹⁹⁴ hence the civil liabilities imposed by section 33 were available¹¹⁹⁵ if its terms were satisfied. Section 33(A) provides two primary bases for recovery that parallel those in the Uniform Securities Act¹¹⁹⁶ and section 12 of the Securities Act of 1933,¹¹⁹⁷ from which it is derived.¹¹⁹⁸ Section 33(A)-(1) gives a purchaser a civil action for so-called "technical violations,"¹¹⁹⁹ i.e., offers or sales of securities that contravene sections 7 and 9 (registration of securities), 12 (registration of dealers and salesman or agents of dealers), 23(B) (improper advertising) or orders the Securities Commissioner issues under section 23(A) to prevent fraud.¹²⁰⁰ Section 33(A)(2) covers offers and sales, whether the securities or transaction are exempted or not, "by means of any untrue statement of a material fact or any omission to state

1191. *E.g.*, *Isenhower v. Bell*, 365 S.W.2d 354, 357 (Tex. 1963); *Wise v. Anderson*, 163 Tex. 608, 611, 359 S.W.2d 876, 879 (1962); *Courseview, Inc. v. Phillips Petroleum Co.*, 158 Tex. 397, 312 S.W.2d 197 (1957); *Moore v. Beakley*, 215 S.W. 957, 958 (Tex. Comm'n App. 1919), *holding approved*; *Rattan v. Bosley*, 446 S.W.2d 345, 347 (Tex. Civ. App.—Waco 1969).

1192. RESTATEMENT OF RESTITUTION § 151, comment *f* at 604, § 160, comment *d* at 643, comments *g-i* at 647-49 (1937).

1193. In a very recent opinion, the Texas Supreme Court reversed the lower court's judgment, primarily on the basis that Meadows should share in the constructive trust res with Bierschwale. The supreme court upheld imposition of the constructive trust, but expressly declined to reach the issues raised under the Texas Securities Act. 516 S.W.2d at 132. The explicit discussion of the Act by the court of civil appeals would thus appear to remain pertinent despite the reversal, and the detailed discussion is included here for that reason.

1194. TEX. REV. CIV. STAT. ANN. art. 581-4(A) (1964) ("The term 'security' or 'securities' shall include any note or other evidence of indebtedness . . ."). *See generally* H. BLOOMENTHAL, *supra* note 1112, § 2.03; 1 L. LOSS, *supra* note 1112, at 546.

1195. TEX. REV. CIV. STAT. ANN. art. 581-33(A) (1964). *See generally* 20 R. HAMILTON, TEXAS BUSINESS ORGANIZATIONS § 757, at 296; Bordwine, *Civil Remedies Under the Texas Securities Laws*, 8 HOUSTON L. REV. 657, 660 (1971); Meer, *supra* note 1159, at 701.

1196. UNIFORM SECURITIES ACT § 410; *see* L. LOSS & E. COWETT, *supra* note 1137, at 389.

1197. 15 U.S.C. § 771(2) (1972).

1198. Comment—1963 Amendment to Art. 581-33, 1B TEX. REV. CIV. STAT. ANN. 69 (1964); *see* L. LOSS & E. COWETT, *supra* note 1137, at 390; Lebowitz, *supra* note 1085, at 116 n.163.

1199. Comment, *supra* note 1197, at 70; Bordwine, *supra* note 1195, at 660.

1200. TEX. REV. CIV. STAT. ANN. art. 581-33(A)(1) (1964).

a material fact necessary in order to make the statements made not misleading (when the person buying the security does not know of the untruth or omission, and who in the exercise of reasonable care could not have known of the untruth or omission)."¹²⁰¹ Given the jury's finding that the plaintiffs had not exercised reasonable care in determining if Oakes' statements were untrue,¹²⁰² it was obvious there could be no recovery under the latter ground and the court so ruled.

This still left section 33(A)(1). Admittedly the notes were not registered as securities under sections 7 and 9 nor was Oakes licensed under section 12 to sell them. Oakes contended, however, that the transaction was exempted by section 5(C)(1) which provides that the Act (except where otherwise specified) does not apply to any sale "made by or in behalf of a vendor . . . in the ordinary course of bona fide personal investment of the personal holdings of such vendor, or change in such investment, if such vendor is not engaged in the business of selling securities and the sales are isolated transactions not made in the course of repeated and successive transactions of a like character"¹²⁰³ The jury found Oakes was not in the business of selling securities and that he had transferred the notes to the plaintiffs in the ordinary course of his bona fide personal investments, but failed to find that the transfer was an isolated transaction not made in the course of repeated and successive similar ones. For this reason the exemption was not available, thus allowing an action to lie under section 33(A)-(1). It is not clear from the opinion whether the jury made a specific finding the transaction was not an isolated one or whether the special issue submitted to it failed to inquire about this needed element. However, there was some evidence that Oakes had taken over several corporations in a similar manner and he was specifically asked what disposition he had made of the stocks he had acquired in those companies. Apparently this was sufficient in the court's view to raise an issue of fact as to whether or not the sale was made in the course of repeated and successive transactions of the same character.

Having determined there was civil liability under section 33, the court concluded the remedy it affords would not preclude relief by way of a constructive trust. Section 33(A) states specifically that a purchaser suing under its provisions may sue either in law or in equity to recover the consideration he paid for the securities purchased if he still owns them or for damages if he does not. In essence, the statute provides for an equitable action for rescission that should be governed by the same general principles of equity as the historic remedy. Here the consideration the plaintiffs gave Oakes for the notes they purchased was the apartment property he later disposed of; it was

1201. *Id.* art. 581-33(A)(2).

1202. The effect of the parenthetical language quoted in the text would appear to place the burden of proof on the purchaser to show he could not have reasonably known of the untruth or omission and this seemed to be the basis for the court's holding that the jury finding would not support a recovery under section 33(A)(2). See Comment, *supra* note 1197, at 69. But cf. Bordwine, *supra* note 1195, at 661, treating the parenthetical language as a defense which the seller-defendant can utilize. Given the statutory language, the first interpretation is more sound.

1203. TEX. REV. CIV. STAT. ANN. art. 581-5(C)(1) (1964).

only equitable, therefore, that they be permitted to gain restitution by tracing and imposing a constructive trust on the proceeds of that disposition as part of their section 33 remedy.

Despite its uniqueness, the result in *Bierschwale* is a salutary one. It conforms to the generally accepted conception of the equitable nature of the statutory civil remedy provided by securities regulation.¹²⁰⁴ It also makes the particular point that in encouraging private enforcement of the securities laws, the relief the legislature has provided need not be limited to recovery of a money judgment.¹²⁰⁵

1204. See 3 L. Loss, *supra* note 1112, at 1635, 1700; cf. A. BROMBERG, *supra* note 1112, §§ 9.1-2.

1205. See, e.g., *Deckert v. Independence Shares Corp.*, 311 U.S. 282, 288-89 (1940); *Whittaker v. Wall*, 226 F.2d 868, 872-73 (8th Cir. 1955); *Corporation Trust Co. v. Logan*, 52 F. Supp. 999, 1004 (D. Del. 1943); cf. *Straley v. Universal Uranium & Milling Corp.*, 289 F.2d 370, 373 (9th Cir. 1961). See generally 3 L. Loss, *supra* note 1112, at 1805; H. SOWARDS, FEDERAL SECURITIES ACT § 9.04[5] (1974).